To my Jane

yes is a pleasant country:
if’s wintry
(my lovely)
let’s open the year

both is the very weather
(not either)
my treasure,
when violets appear

love is a deeper season
than reason;
my sweet one
(and april’s where we’re)

E.E. Cummings

INTRODUCTION

Scope of this book

The focus of this book is the taxation of individuals who are resident but not domiciled in the UK. But one cannot discuss that without addressing the taxation of non-resident individuals, trusts and companies, and often foreign aspects can only sensibly be discussed in the context of the provisions as a whole. By expanding to these wider topics this book is in danger of bursting its banks, but I hope as a result that much of the discussion will be also helpful to those advising non-residents, and UK domiciled individuals where there is any offshore aspect to their affairs.

Current trends in tax reform

It is only a year since the last edition but the pace of tax reform is frenetic.

The Finance Bill is ceasing to be the last stage of enacting tax reform, and becoming instead an early and incomplete sketch of proposals not intended to be ready for enactment. This the Government candidly announced in respect of the taxation of foreign profits[1] and new enforcement rules.[2]

Retrospective legislation is becoming common, in part as a response to tax avoidance and in part as a method of correcting inadequacies in recently enacted ill-thought out legislation (as in the FA 2009 changes to the remittance basis.)

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1 Letter from the Financial Secretary to the Treasury 30 April 2009 accessible *www.hmrc.gov.uk/finance_bill2009/fb09.pdf*. "The Finance Bill was published as work in progress;" House of Lords Economic Affairs Committee report on the Finance Bill 2009 accessible *www.publications.parliament.uk/pa/ld/ldeconaf.htm*.

2 "If we consulted in detail on legislation like this before including in in a Bill, we would never get the Bill... I would urge the hon. Gentleman not to believe that he can undertake meaningful consultation before first producing something in a Finance Bill..." - Geoffrey Robinson, Hansard 13 May 2009 col 874 on what became s. 93 FA 2009 (Duties of senior accounting officers of qualifying companies).

Another trend is increasing uncertainty, caused in particular by frequent use of wide ranging (so-called) TAARs.

HMRC guidance has increased in quantity. Guidance on the 2008 changes has poured out, with lengthy Qs & As in January, February and March 2009 and followed by countless pages of guidance (draft manuals) including 274 pages on the remittance basis alone.

Underlying these trends is an impatience with rules and with taxpayers who would like to rely on them.

The most talked about change is the proposed increase in the rate of income tax to 50%. However the shock of the year was the publication of HRMC 6, a major change in tax policy published at six days notice, without consultation, which returns the law and practice of residence to the state of complete uncertainty from which it had emerged in the 1930's. It seems safe to predict that this position is unlikely to endure.

Thanks ...

I am very grateful to Peter Vaines my co-author on an earlier book on this topic, to Robert Venables QC and Stephen Brandon QC for discussions on many aspects of tax and to many readers for helpful comments. I owe a great debt to Jane Hunt who patiently types and re-types the intractable manuscript.

... and request for help

Comments from readers would be of the greatest value and interest to the author. It has taken a full 12 months, and very many pages, to complete a *preliminary* analysis of the provisions which rushed through in what the House of Lords Economic Select Affairs Committee called the "absolute shambles" of the FA 2008. I am conscious that there is still more work to be done to complete a fuller analysis. In particular, there has not been time to fully assimilate the contents of the HMRC guidance.

The pleasure in writing this book consists in the interest of the questions which it raises and the success which it may have achieved in answering them.

Size of this book

Another trend in UK tax is increasing length. This year the Tax Law Rewrite has given the Corporation Tax Act 2009. This is the longest Bill Parliament has ever considered. The list of contents is 63 pages long. Yet it only contains half of corporation tax legislation and is to be followed by a second CT Act in 2011.

In the 7th edition of this work I concluded the preface saying:

> Tax legislation is so voluminous that no-one can now read it. I cannot even *carry* it.

In the debate on the Corporation Tax Bill 2009 Lord Newton (chairman of the tax law rewrite steering committee) made the same point but he was not (I think) speaking in jest:

> The weight of the documents [the four volumes of the Corporation Tax Bill] —even the weight of the Explanatory Memorandum [another four volumes] —is such that I have not strained myself by bringing them into the Chamber.[3]

It is a new development that the size of UK tax legislation is to be measured not in the number of words, or pages (both long since unascertainable) but in kilograms.

These are bad times for tax policy. The current method of producing tax legislation is a failure by every possible measure, and pressure to reform it is (quite understandably) accumulating; for now we continue to sow the wind and reap the whirlwind. The conclusive proof of that proposition lies in seeking to state the law, as this book seeks to do, as at 1 August 2009, or in seeking to understand the law, as you the reader will do now.

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3 Hansard, 25 March 2009 *www.publications.parliament.uk/pa/ld200809/ldhansrd/text/90325-0011.htm*.

TDF Online

TFD online is an online version of Taxation of Foreign Domiciliaries, and more.

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(3) to contribute to the discussion pages
(4) to search the text or to access it on screen

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TFD online is moderated by Amanda Hardy, a member of Tax Chambers, 15 Old Square, Lincoln's Inn. It is in technical terms a Wiki,[1] on the lines of Wikipedia.

To access TFD go to *www.foreigndomiciliaries.co.uk*

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1 http://en.wikipedia.org/wiki/Wiki.

Trusts Discussion Forum

Readers are invited to join the Trusts Discussion Forum, an internet discussion group dedicated to discussion of trusts and related private client topics, initiated by the author in association with STEP and the Chancery Bar Association.

For further information on the forum and to subscribe visit *www.trustsdiscussionforum.co.uk*
There is no charge.

A Note to the Lay Reader

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

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TABLE OF ABBREVIATIONS

Statutes and Statutory Instruments

CA	:	Companies Act
FA	:	Finance Act
FB	:	Finance Bill
FSMA	:	Financial Services & Markets Act 2000
ICTA	:	Income and Corporation Taxes Act 1988
IHTA	:	Inheritance Tax Act 1984
ITA	:	Income Tax Act 2007
ITEPA	:	Income Tax (Earnings and Pensions) Act 2003
ITTOIA	:	Income Tax (Trading and Other Income) Act 2005
SSCBA	:	Social Security Contributions and Benefits Act 1992
SSCER	:	Social Security (Categorisation of Earners) Regs 1978
SSCR	:	Social Security (Contributions) Regs 2001
TCGA	:	Taxation of Chargeable Gains Act 1992
TLATA	:	Trusts of Land and Appointment of Trustees Act 1996
TMA	:	Taxes Management Act 1970
VTA	:	Variation of Trusts Act 1958

Periodicals

BTR	:	British Tax Review
OITR	:	Offshore & International Taxation Review
OTPR	:	Offshore Tax Planning Review *Renamed Offshore Taxation Review in 1997 and renamed (again) as OITR in 1999*
PCB	:	Private Client Business
PTPR	:	Personal Tax Planning Review

HMRC Manuals and Publications

BIM	:	Business Income Manual
CG Manual	:	Capital Gains Manual
CT Manual	:	Company Taxation Manual
EI Manual	:	Employment Income Manual
IR20	:	Residence and Domicile
INTM	:	International Manual
IPT Manual	:	Insurance Premium Tax Manual
ITH	:	International Tax Handbook
NI Manual	:	National Insurance Manual
PI Manual	:	Property Income Manual

SAI Manual	:	Savings & Investment Manual (*HMRC sometimes call this the Savings & Investment Income Manual*)
TSE Manual	:	Trusts Settlements and Estates Manual

Other

AIP	:	Accrued Income Profits
AUT	:	Authorised unit trust
BPR	:	Business property relief (for IHT)
CFC	:	Controlled foreign company
CGT	:	Capital Gains Tax
DDS	:	Deeply discounted security
DRs	:	Depository receipts
DT	:	Discretionary trust
DTT	:	Double taxation treaty
ECHR	:	European Convention on Human Rights
EN	:	Explanatory Notes
ESC	:	Extra-statutory concession
FoE	:	Freedom of establishment
GB	:	Great Britain
GWR	:	Gift with reservation of benefit
HMRC	:	Her Majesty's Revenue and Customs
IHT	:	Inheritance tax
IME	:	Investment manager exemptions
IOV	:	Instrument of variation
IP	:	Interest in possession
IPDI	:	Immediate post-death interest
IT	:	Income tax
MS	:	Member State
NICs:	:	National insurance contributions
NOR	:	Not ordinarily resident
OEIC	:	Open-ended investment company
OIG	:	Offshore income gain
PE	:	Permanent establishment
PET	:	Potentially exempt transfer
POA	:	Pre-owned assets
PRs	:	Personal representatives
RFI	:	Relevant foreign income
RI	:	Revenue Interpretation
SDLT	:	Stamp Duty Land Tax
SP	:	Statement of Practice
TAA	:	Transfer of Assets Abroad
TDSI	:	Tax deduction scheme for interest
TSI	:	Transitional Serial Interest

DISCLAIMER

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CHAPTER ONE

FOREIGN DOMICILE TAX REFORM

1.1 Policy issues in foreign domiciliary taxation

This section considers policy arguments for and against a lighter fiscal regime for foreign domiciliaries (or some similar class of footloose individuals).[1]

1.1.1 *Economic arguments*

Foreign domiciled individuals in general have a choice where to reside. If their tax burden was as great as that of a UK domiciliary fewer would choose to live in the UK, and the UK economy would lose:

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

There is no shortage of low-tax or preferential tax regimes to which wealthy individuals can move. Switzerland, for instance, has a lump sum taxation regime for non-Swiss citizens specifically targeted for this purpose.[2] Where there is tax competition, the term "customer," which

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1 For discussion on policy issues, see 'Residence and Domicile: Response to Background Paper' (STEP, 16 June 2003); 'Reviewing the Residence and Domicile Rules' (CIOT, 1 August, 2003); PBRN18 (Residence & Domicile Review), CIOT, 20 November 2007; all accessible on *www.kessler.co.uk*.

2 Though this is currently politically controversial and its future is uncertain.
The OECD study "Engaging with High Net Worth Individuals on Tax Compliance" para 34 (May 2009) singles out Ireland, France, the Netherlands and the UK for what it terms "preferential regimes for specifically defined groups of taxpayers";

HMRC have (controversially) applied to taxpayers since 2001 seems almost apt.[3] UK resident foreign domiciliaries are generally in a better position than other taxpayers to take their custom elsewhere.

Also, UK firms competing for expertise in the international labour market will find recruitment easier if the tax regime for foreign employees is lighter. Some potential employees would not chose, or could not afford, to come if the UK tried to tax them as it does its own domiciliaries.

Where the UK faces international tax competition, those making the law sometimes accept the need for pragmatism:

> Overseas investors are in theory liable to inheritance tax on their OEIC and AUT holdings, because they are regarded as being situated in the UK for tax purposes on the investors' death. Competing centres do not charge tax in parallel circumstances. ...[4] Removing the potential inheritance tax charge will help UK managers compete on an equal

see *www.oecd.org/dataoecd/5/25/42798312.pdf*

3 A note on this terminology. It was about 2001 HMRC began to refer to taxpayers as "customers." A press release at the time provided: (14/06/01) "M and C Saatchi, a leading advertising agency, has been appointed by the IR to rebrand the department. Branding and design consultants, Corporate Edge, will also be working with the IR and M and C Saatchi to 'create a customer driven department.'"
In 2003 Sir Nicholas Montagu (then Chairman of the Board of Inland Revenue) said that the reason for the change was to remind Revenue staff that the needs of the consumer of public services should be considered first: see "The Customer is always right" Tax Advisor February 2003.
The terminology will probably be dropped sooner or later. No other Revenue department in the world has adopted it. It continues to give rise to derision among tax practitioners. See eg "Customer Service?" Julie Cameron, *Taxation* 10 Apr 2008, p.361 "It never ceases to amaze me that HMRC have adopted the word 'customer' to describe the taxpaying public. A customer is someone who chooses to patronise a business." Andy Wells agrees: "I will never be a "customer" of HMRC. This disregard for the English language irks just about every tax professional I come across..." *Taxation* 4 June 2009, p.549.)

4 The text continues: "This very rarely generates any significant yield, because UK assets still have to exceed the inheritance tax threshold ... before any tax is due. But it is a deterrent in marketing terms". I suspect that the true reasons that the old IHT charge raised little IHT was rather different, namely that no-one (if properly advised and wishing to comply with UK tax rules) would invest more than the IHT threshold in AUTs or OEICs within the IHT regime. Undetectable non-compliance must also be reckoned with. But that does not affect the point made here.

footing with overseas fund providers.[5]

In assessing the attractiveness of the UK relative to other countries several points must be borne in mind. Effective low tax is often achieved in other countries by formal or informal concession rather than by law. One paragraph summaries of other countries are bound to be misleading.

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

> Frequent changes in legislation, particularly where there has been an absence of consultation, can have an adverse impact on the taxpayers and their advisers trust in the tax system.[6]

But there are others: can a tax authority subject an individual to an expensive tax investigation without any evidence to justify doing so? Certainty is very important. Perception matters as much as reality. By many of these measures, the UK scores poorly.[7]

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5 Press Release 16 October 2002 (OEICs and AUTs) para 6. Another example: "The location of ownership, flagging (registration) and management activities is very 'footloose', since it can easily be transferred from one country to another. This makes it vital to have regard to the fiscal regimes in other countries if we want to maintain a successful shipping industry in the UK. The modern armoury in the battle for success invariably includes a virtually tax-exempt fiscal regime." (Independent Enquiry into a Tonnage Tax, Lord Alexander, HM Treasury 1999.) Another example is the exemption granted to performers in the 2012 Olympic Games: s.68 FA 2006.
This sort of tax competition against other countries might be thought undesirable. But this consideration assumes a level of international fiscal co-operation that does not yet exist, though from time to time it hovers as an element in tax policy.

6 "Engaging with High Net Worth Individuals on Tax Compliance" (May 2009) para 208 and 243; see *www.oecd.org/dataoecd/5/25/42798312.pdf.*

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

> "For all fund types, the UK tax regime is viewed less favourably than those of Ireland and Luxembourg ...The negative perception of the UK tax regime is driven more by uncertainty than by any specific factor. . A key feature of [structured] products is that promoters must be as certain as possible of the tax analysis for investors over a period of five years and more, and hence the uncertainty of the UK regime in this area makes the UK an unsuitable domicile

In the 6th and earlier editions of this book, I said:

> The UK tax system is largely[8] based on the rule of law rather than informal practice and discretion.

To the extent this is true it is something to boast of,[9] and a feature which makes the UK an attractive choice for anyone choosing where to reside. However, it is rapidly becoming less true, due to:

(1) over-wide, over-complex, or wholly vague anti-avoidance provisions mitigated by informal practice, discretion or plain oversight.[10]
(2) an increasing use of retrospective legislation.[11]

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

8 But see 9.25 (Forward tax agreements).

9 I know of no way of persuading those who would disagree with this, but if authority is needed, see Blackstone's Commentaries (1765) vol 2 chap 37 ("a country like this, which boasts of being governed in all respects by law and not by will...").

10 Examples include the POA rules (2004); restrictions on CGT losses (2007); the ITA remittance rules (2008).

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

The economic argument is crucial but what will be the economic effect of any reform is very hard to tell.

1.1.2 *Fairness*

The other main consideration is fairness or (more analytically) horizontal equity, the view that people who are relevantly equal should pay the same amount of tax. Of course this begs the question of whether UK resident UK domiciliaries and UK resident foreign domiciliaries are relevantly equal. To regard the two as completely equivalent is facile. It seems fair that those whose links with the UK are significantly less should pay less tax on foreign income or gains. This is especially so bearing in mind that "residence" does not require a very close connection to the UK – merely passing the 183 or 91 day tests or (under HMRC 6) having vaguer and more remote connections. Further, a foreign domiciliary may not have had a fair opportunity to arrange his affairs with UK tax in mind; for instance creating settlements from which he was excluded.

Another consideration is the impracticality (both for taxpayers and HMRC) of untangling ownership of assets, especially in family ownership arrangements which are common in third world countries.

1.2 Approaches to reform of foreign domiciliary taxation

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

(1) Alter the definition of domicile for general purposes and so restrict the class who qualify for foreign domicile tax treatment.
(2) Alter the definition of foreign domicile for some or all tax purposes.
(3) Alter tax laws applying to all foreign domiciliaries.
(4) Identify subclasses of foreign domiciliaries with close UK links so as to tax them more heavily.

One can of course achieve the same end result by more than one technique.

There is a lot to be said for approach (4). The domicile concept is not ideally framed to identify the "footloose" individuals, whose UK links are less, and for whom a lighter tax regime is appropriate. The adhesive quality of a domicile of origin, and the restrictive rules for the acquisition of a domicile of choice, allow some fortunate individuals to enjoy foreign domicile tax treatment, despite very close UK links and only tenuous, historical and fortuitous links to their domicile of origin. To the extent that they do so the tax system fails both on the economic and the fairness criteria.

The IHT code has to an extent recognised this with its deemed domicile rule. The TAA provisions also recognise this (restricted to ordinarily residents).

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

1.3 History of reform of foreign domicile taxation

1.3.1 *1974-2002*

The 1974 Finance Bill included a provision (clause 18) that an individual ordinarily resident in the UK for five out of the preceding six years of assessment should be regarded as domiciled here for IT and CGT purposes. This was withdrawn from the Bill.[12]

In 1987 the Law Commission published recommendations for minor reforms of the general law of domicile but despite initial acceptance by the Government, there was no change in the law. In 1996 the proposals were formally abandoned.[13]

The 1988 Consultative Document (Residence in the UK) made radical proposals. The remittance basis would be abolished. Those resident here for less than seven out of 14 years (and, perhaps, who are also not UK

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12 For an account of the lobbying behind this, see "Inside The Treasury", Joel Barnett, Andrew Deutsch, 1982, p.28–9.

13 Law Com. No. 168: The Law of Domicile accessible *www.scotlawcom.gov.uk/downloads/rep107.pdf.* According to Hansard HC, 16 Jan 1996 Col 487:
"The Government have decided not to take forward these reforms on the basis that, although they are desirable in themselves, they do not contain sufficient practical benefit to outweigh the risks of proceeding with them and to justify disturbing the present long established body of case law on this subject."
This was the right reason for the right decision. However, the true reason for the decision may well have been pressure of the foreign domicile lobby: see "Rules for Determining Domicile", Law Reform Commission of Hong Kong (2005) para 4.28 accessible *www.hkreform.gov.hk.*

domiciled) would qualify for a new "intermediate basis" of taxation. This would require disclosure of worldwide income in order to tax it at an effective rate of 2% or less. This almost unworkable proposal was sensibly abandoned.

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

> It seems more likely than not that, apart from tinkering changes, the present regime will continue for the foreseeable future. But "the major distinguishing feature of the British tax system is its instability".[14] There is also the possibility of EU pressure for reform.[15] If what has been a backwater acquires political prominence, perhaps due to no more than a campaign by a single newspaper, there will certainly be major changes.

1.3.2 *The 2003 background paper on residence and domicile*

In 2002 a newspaper campaign emerged[16] which pressed the Government into action, or at least into the appearance of action. The Budget of April 2003 delivered a "background paper" called "Reviewing the Residence and Domicile Rules as they affect Taxation".[17] This was a facile document[18] but it may be unfair to criticise its (unnamed) authors. Their instructions may have been to be uncontroversial; by saying nothing, there was nothing in the document to which anyone of any political view could object.

Nothing then happened for five years except the often repeated statement

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14 This was noted in *Taxation and Democracy*, Sven Steinmo, Yale University Press, 1993, p.44 but the instability has markedly increased since then.

15 For instance the EU required the UK to end its former discrimination against Irish source income; see the 6th edition of this work, para.9.51.

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

17 See *www.hmrc.gov.uk/budget2003/residence_domicile.pdf.*

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

that:

> The review of the residence and domicile rules ... is ongoing.[19]

It is clear that the review of foreign domicile tax did not follow the normal course of consultation, decision and implementation. In the absence of a frank explanation of what went on, it is tempting to speculate. The most likely explanation is that the Blair Government wanted to do nothing, but prevaricated to avoid an announcement which would have lead to a furore from those in favour of reform.[20] A change of power led to an unannounced U-turn from that unannounced policy.

1.4 Assessment of the 2008 reforms

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

> [1] should be fair;
> [2] should support the competitiveness of the UK economy; and
> [3] should be clear and easy to operate.[21]

It seems reasonable to assess the 2008 reforms by these criteria.

1.4.1 *Clear and easy to operate*

It will be evident to anyone who reads this book that by this criteria the rules are an abject failure. The rules are unclear, often difficult and

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19 Para.5.120 Budget Report 2007 (21 March 2007); para. 5.104 Budget Report 2006 (22 March 2006); para. 5.103 Pre-Budget Report 2005 (5 December 2005); para. 5.116 Budget Report 2005 (16 March 2005); para.5.101 Pre-Budget Report 2004 (2 December 2004); para.5.103 Budget Report 2004 (17 March 2004); para.5.108 Pre-Budget Report 2003 (10 December 2003); all accessible on HM Treasury Website. Also see *Hansard* 16 October 2006 Col 1067W. The last outing of the tired statement was Hansard 12 July 2007 Col 1605 by which time almost no-one believed it, but by then it was possibly true.

20 See *The Rise of Political Lying*, Peter Oborne, 2005, The Free Press.

21 The paper might have cited Adam Smith's *The Wealth of Nations* (1776) Book 5 chapter 2, accessible *www.adamsmith.org/smith/won-intro.htm*.
The paper did not point out (though Adam Smith did) that these objectives are to a substantial extent irreconcilable.

frequently impossible to operate. In these respects they are unquestionably worse than the pre-2008 rules. Government policy normally requires an impact assessment.[22] None was carried out in relation to any of the 2008 reforms. Many features of the reforms could not have survived if it had been.

1.4.2 *Competitiveness of the UK economy*

A thorough investigation of the economic effect of the 2008 reforms would need a team with expertise in tax and economics. No investigation of this kind has been made.

On one side of the account is the gain of more tax paid by foreign domiciliaries. On the other is tax and investment lost from individuals who leave the UK, and those who (because of the reforms) decide not to come. It is certainly a serious loss to the economy that the new rules in many cases prevent investment in the UK and prevent use of UK services.

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

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

This view is now supported by a KPMG survey of 80 foreign domiciliaries finding that 24% are planning to leave the UK in the next two years as a result of the changes in 2008, with an additional 24% hoping that the rules will be changed and looking to review their position in the medium term. More than nine out of ten said that the changes had damaged the UK's

22 *www.berr.gov.uk/files/file44544.pdf*

competitiveness.[23] The greater loss may not be those leaving but those who do not come, a loss more or less impossible to measure statistically but no less real for that.

1.4.3 *Fairness*

One item of the 2008 reforms – the £30k remittance basis charge – takes the approach advocated above of distinguishing between different foreign domiciliaries and taxing those more heavily with greater UK connections, the connecting factor here being an 8/10 year residence test. One cannot categorise that as unfair.

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

The new ITA remittance basis is not wholly unfair, except for the wilder reaches of the relevant person definition.

The new CGT rules for trusts can work unfairly but complete fairness is impossible to achieve in this area.

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

All in all, the reform cannot score many marks for fairness.

1.4.4 *Process of implementation*

The manner in which the new law was introduced deserves to be recorded.

On 18 January 2008, 26 pages of draft clauses were published whose unwritten message to wealthy non-residents was broadly: *do not come to the UK if possible; if you must, do not under any circumstances invest any money here*. The clauses were officially described as work in progress, but this was unfit for publication.

HMRC presumably agreed. On 27 March the Finance Bill was published, containing 54 pages of legislation. The FB clauses bore almost no resemblance to the January draft. One consequence is that the professional

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23 March 2009, accessible *www.kpmg.co.uk/news/docs/NomDoms_FinanceAct2008_Access3.pdf*

time and clients' money spend considering the old clauses was almost entirely wasted. That certainly cost many £millions. Another consequence was that the profession had nine frantic days to scramble around before the end of the tax year. Because of the absence of sensible transitional reliefs, large amounts of tax depended on decisions and actions taken in those days. Sensible consideration of difficult and important matters was rendered impossible.

On the date of publication the Treasury announced that the Finance Bill was incomplete and amendments covering almost every aspect of the rules[24] would be made in the course of progress of the Finance Bill.[25] Thirty pages of amendments duly emerged in mid June – far too late in the Finance Bill timetable to give them any serious consideration. Forty eight more Report Stage amendments were published on 26 June. The report stage and third reading (after which no further amendments could be made) were held on 1 and 2 July 2008. John Avery Jones notes that "Report Stage amendments are usually a disaster."[26]

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

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

> Our private sector witnesses would not have used words like "a real shambles" if they did not feel strongly about this. ...
> 176. We recommend that, if they have not already done so, HMT and HMRC should carry out a full review of the reasons why there were so

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

25 In the 2008/09 edition I said:
"This is a new development in tax legislation. While from time to time inadequately drafted clauses have always been found in Finance Bills, this is as far as I am aware the first time that the Government has had to announce that fact at the time of publication of the Finance Bill."
It seems however to be a trend as there are similar examples in the FA 2009.

26 See "Taxing Foreign Income from Pitt to the Tax Law Rewrite—The Decline of the Remittance Basis", John Avery Jones in *Studies in the History of Tax Law*, Hart Publishing, 2004 accessible on *www.kessler.co.uk*.

> many difficulties in the development of this policy initiative. They should ensure that the lessons are learned so that these problems do not emerge in other initiatives.

No such review has been carried out and there is no sign that the lessons have been learned.

> 177. We also recommend that if another policy initiative gets to the point where the legislation cannot be finalised for inclusion in the Finance Bill, that initiative should not be included in the Bill, or, if feasible, the part which is not finalised should not be included. We cannot support the approach of the Finance Bill's still being subject too much amendment at the time it is published, particularly when the proposals come into effect from the beginning of the tax year, as in this case. [27]

The former editor of *Taxation* is more blunt – and no-one who studies this book will disagree:

> The standard of strategic policy making at the Treasury has been unacceptably poor in recent years, but this must surely have been one of its lowest ebbs ever.[28]

1.4.5 *The future*

Alistair Darling said in his budget speech 2008:

> There will be no further changes to this regime [for foreign domiciliaries] for the rest of this Parliament or the next.[29]

No-one seriously believed that[30] and in the 2008/09 edition of this work I

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

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

29 *www.hm-treasury.gov.uk/budget/budget_08/bud_bud08_speech.cfm.*

30 The House of Lords Economic Affairs Committee said:
"227. In his Budget Statement, the Chancellor promised that the rules in this area would not be substantially revised for the rest of this or the next Parliament. We do not take this to mean that there will not be legislation in coming Finance Bills to address defects in the current legislation. We think it inevitable that, given the

said:

> The statement is constitutionally wrong, as Parliament cannot bind its successor. But leaving aside (if one can) constitutional fundamentals, it would be rash to rely on it. On the contrary, I predict that further tinkering (at least) is likely as the effect of the present rules gradually becomes evident.

The FA 2009 has done just that, and more tinkering is already promised in the FA 2010. The current position is highly unstable and it is not likely that the law is likely to remain in its present form.

evident pressure under which this legislation was produced, there will be such defects." 2nd Report of Session 2007–08, The Finance Bill 2008 *www.publications.parliament.uk/pa/ld200708/ldselect/ldeconaf/117/117i.pdf.*

CHAPTER TWO

DOMICILE

2.1 Why does domicile matter?

Domicile is fundamental for many tax purposes, of which the most important are:

(1) The remittance basis for IT and CGT.
(2) IHT on foreign situate assets.

Domicile is also important for many non-tax purposes.

For the IHT deemed domicile rules, see 43.1 (Deemed domicile for IHT).

2.2 The concept of domicile

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

The law in Scotland is (almost) the same as England, and indeed the leading case of *Udny v Udny* is a Scottish case. The law in Northern Ireland is the same as England.

IHT Manual 13000 sets out a brief and uncontentious summary. HMRC published a lengthy "new technical guidance on domicile" discussion as part of its guidance on the 2008 changes.[1] For a further discussion of the general law of domicile, see Dicey and Morris, *Conflict of Laws*, 14th edition, 2006 ("Dicey"). This is the book that HMRC and the courts always cite.

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1 Currently accessible as a self standing document from *www.hmrc.gov.uk/cnr/res-dom-tax-amends.htm* but we are told "This will move to the RDR manual in due course".

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

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

Everyone has one and only one domicile. The expression "**non-domiciled**" is in a literal sense inapt, because everyone is domiciled somewhere. It is, however, an acceptable and convenient abbreviation (in context) for non-UK domiciled (just as "non-resident" means, in context, non-UK resident).

A person must be domiciled in a single legal jurisdiction. The expression "**UK domiciled**" is in a literal sense inapt because a person must be domiciled in England, Scotland or Northern Ireland. It is, however, universally used to describe someone who is domiciled in England, Scotland or Northern Ireland. For tax purposes it makes no difference where in the UK one is domiciled, though for general law purposes it may be important.

2.3 Domicile of origin

Dicey states:

> Rule 9 – (1) Every person receives at birth a domicile of origin:
> (a) A legitimate child born during the lifetime of his father has his domicile of origin in the country in which his father was domiciled at the time of his birth;
> (b) A legitimate child not born during the lifetime of his father, or an illegitimate child, has his domicile of origin in the country in which his mother was domiciled at the time of his birth; ...

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

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

> (2) A domicile of origin may be changed as a result of adoption, but not otherwise.[4]

This is one of the few areas of English law where legitimacy still matters.

2.4 Acquisition of domicile of choice

Dicey states:

> Rule 10 – Every independent person can acquire a domicile of choice by the combination of residence and intention of permanent or indefinite residence, but not otherwise.[5]

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

2.4.1 *"Residence"*

"Residence" here means "residence as an inhabitant" which is something more than "presence as a traveller".[6] This is not quite the same as residence for tax purposes. Assuming a person resides as an inhabitant, there is no minimum period of residence required: residence commences immediately on arrival if the intention is to stay.[7]

2.4.2 *"Permanent or indefinite" residence*

"Permanent" residence is straightforward but the concept of "indefinite" residence needs comment. "Indefinite" here means that the individual intends to reside in a country for the foreseeable future. "Unlimited" is sometimes used to express the same idea but even this needs clarification. *IRC v Bullock* 51 TC 522 commented on the classic *dictum* that a domicile of choice is acquired when:

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4 *Conflict of Laws*, 14th ed., para 6R-025.

5 *Conflict of Laws*, 14th ed., para 6R-033.

6 This is irrelevant to acquisition of a domicile of choice, because a person acquiring a domicile of choice in a country must *ex hypothesi* have the intention to reside there permanently, so his residence there must be "as an inhabitant" and not "as a traveller". But the point may be relevant for loss of domicile of choice.

7 *Fasbender v AG* [1922] 2 Ch 850 at p.858; *Bell v Kennedy* (1868) LR 1 Sc & Div 307 at p.320.

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

Buckley LJ said at p.540:

> I accept that statement ... with this qualification only that the expression “unlimited time” requires some further definition. A man might remove to another country because he had obtained employment there without knowing how long that employment would continue but without intending to reside there after he ceased to be employed. His prospective residence in a foreign country would be indefinite but would not be unlimited in the relevant sense. On the other hand, ... I do not think that it is necessary to show that the intention to make a home in the new country is irrevocable or that the person whose intention is under consideration believes that for reasons of health or otherwise he will have no opportunity to change his mind. In my judgment, the true test is whether he intends to make his home in the new country until the end of his days unless and until something happens to make him change his mind.

The requirement to intend to reside somewhere “indefinitely” is very strict. In *IRC v Bullock* 51 TC 522 the taxpayer resided in England for 40 years but he always hoped to return to his home of Nova Scotia (to which his wife objected) should he survive her or persuade her to change her mind. This contingency had sufficient substance to represent a real determination to return home rather than a vague hope or aspiration. Mr Bullock did not acquire a UK domicile of choice but retained his domicile of origin.[8]

This may be contrasted with *Furse v IRC* [1980] STC 596 where the taxpayer intended to live in England for the rest of his life save only for a contingency that he would return to America in the event that he were to become physically incapable of taking an active interest in his UK farm. This was said to be too insubstantial and accordingly Mr Furse acquired a domicile of choice in England:

> If a man intends to return to the land of his birth upon a clearly foreseen and reasonably anticipated contingency, e.g., the end of his job, the

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8 For other examples of long periods of UK residence without acquiring a UK domicile see *Buswell v IRC* 49 TC 334 and *Cyganik v Agulian* [2006] ITELR 762.

> intention required by law is lacking; but, if he has in mind only a vague possibility, such as making a fortune (a modern example might be winning a football pool), or some sentiment about dying in the land of his fathers, such a state of mind is consistent with the intention required by law.

The test is where the individual would wish to "end his days".[9]

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

2.4.3 *Proof of intention*

In the event of a dispute the court must determine what is or was the individual's intention. In order to do so the court will have regard to every factor which might shed light on the individual's intention – except registration and voting as an overseas elector (which will be ignored in a tax appeal unless the taxpayer wishes otherwise).[10]

The burden of proof lies on HMRC to show that an individual has acquired a UK domicile of choice. The courts regard the acquisition of a domicile of choice as a serious matter which is to be found only on clear and compelling evidence.[11] However, "the importance of onus of proof is easily exaggerated. While the burden of proof always exists, few substantial cases turn upon it and in making his factual findings the judge is usually expressing his considered judgment as to what in truth occurred".[12] If that is right, then the reform often proposed of amending

9 *Barlow Clowes International v Henwood* [2008] EWCA Civ 577 at [10] to [15].

10 See s.200 FA 1996. This unprincipled provision was intended to encourage UK expatriates to vote without imperiling their claim to be non-UK domiciled: it did not help the Government in the 1997 election. (In practice if voting was not mentioned in evidence, a judge might make a quiet inference that the individual did do so.)

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

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

the burden of proof in domicile cases will have no practical effect.

2.5 Retaining foreign domicile of origin while UK resident

The question for a person with a foreign domicile of origin is whether he will acquire a domicile of choice in the UK. The key to the acquisition of a domicile of choice is the combination of two factors, physical and mental. The individual must:

(1) physically reside in England, Scotland or Northern Ireland; and
(2) form the intention to live there permanently or indefinitely, in the sense explained above.

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

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

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

The individual should if possible retain ties with their country of origin. There are many ways by which they might do so and she need not adopt them all. Possibilities for consideration include regular and extended visits home; local business interests, bank accounts and investments; membership of local social, political and religious organisations. The individual should make a will taking effect under local law.[13] The will should include a declaration that the individual intends to return home in due course or the circumstances in which that is to occur. The will might also express a desire to be buried in that country if possible. The

13 An additional UK will may also be appropriate to deal with UK property.

declaration should be drafted carefully, in accordance with the individual's circumstances; a simple declaration of domicile is inadequate.[14]

Conversely, the individual's social and business commitments in the UK should be minimised. The purchase of a home in this country could indicate a degree of permanence which would not be the case with rented accommodation, but purchasing a property may imply nothing more than an intention of medium-term residence. Involvement in domestic politics or the development of other long-term commitments to the community, such as changing ones name (or its spelling) to accord with UK usage, are to be avoided.

The purchase of a burial plot provides some indication of an intention to be buried in that territory at the time of purchase. If that is the territory of residence it might indicate an intention to remain in that country for the rest of the individual's life. If the burial plot is in the country of origin it provides some evidence of an intention to return home in due course. However, this is not necessarily a matter which deserves much weight.

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

2.6 Acquisition of foreign domicile of choice by individual with UK domicile of origin

The domicile rules are favourable to the foreign domiciliary since he may stay many years in this country without acquiring a UK domicile and becoming exposed to the concomitant tax burden. But the rules are correspondingly unfavourable to the individual who wishes to replace his UK domicile of origin by the acquisition of a foreign domicile of choice.

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14 For an example of a simple declaration rightly disregarded, see *Reddington v MacInnes* [2002] ScotCS 46 accessible *www.bailii.org*. (If those drafting the will had considered domicile more carefully, the litigation might have been avoided.) For precedents, see James Kessler, *Drafting Trusts & Will Trusts*, Sweet & Maxwell, 8th edn, para 17.24 (Best form of will for foreign domiciled testator).

Such a person must not only reside in that other country; he must maintain and manifest his intention to remain resident there permanently.

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

The acquisition of a foreign domicile which is motivated purely by tax considerations is difficult for practical reasons: the intention to live in the territory may prove to be insufficiently firm. The story of Sir Charles Clore is an example. The last two years of his life were saddened by his move to Monaco (where he moved with the intention of losing his UK domicile of origin) and he often thought of returning to England which he called "home". In such circumstances he was not surprisingly held to have remained domiciled in the UK: *Re Clore (No. 2)* [1984] STC 609.

On the other hand, if a UK domiciliary has plans of a business or personal nature which lead him to want to live abroad, then the further step of acquiring a foreign domicile may be feasible.

2.7 Loss of domicile of choice

Dicey states:

> Rule 13 – (1) A person abandons a domicile of choice in a country by ceasing to reside there and by ceasing to intend to reside there permanently or indefinitely, and not otherwise.

For the meaning of "reside" and "indefinitely" see 2.4 (Acquisition of domicile of choice). Dicey continues:

> (2) When a domicile of choice is abandoned, either
> (i) a new domicile of choice is acquired; or
> (ii) the domicile of origin revives.[15]

15 *Conflict of Laws*, 14th ed., paras 6R-033 and 6R-074.

2.8 Retaining a foreign domicile of choice

The concern of a person who has a UK domicile of origin but has acquired a foreign domicile of choice is that he may lose his domicile of choice. He must:

(1) maintain his residence in the country of domicile of choice; or
(2) maintain the intention to reside there permanently; or
(3) acquire a new foreign domicile of choice.

2.9 Dual residence and domicile

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

2.9.1 *Acquisition of domicile of choice by dual resident*

In *Udny v Udny*,[16] Lord Westbury said that a domicile of choice is acquired when:

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

If a person resides in a number of countries, it is considered that he acquires a domicile of choice in country A if and only if:

(1) country A is his chief residence; and
(2) his intention is permanently to reside in country A as his chief residence.

This is, on reflection, the only sensible rule.

Plummer v IRC 60 TC 452 commented on the *Udny* dictum. Hoffmann J said:

16 (1869) LR 1 Sc & Div App 441 at p.458. (Emphasis added.)

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

This should not be controversial.[17]

2.9.2 *Loss of domicile of choice by dual resident*

The judge continued:

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

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

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

(1) *Loss of domicile of origin.* The only way to "lose" a domicile of origin is to acquire a domicile of choice. This passage (so far as it concerns a domicile of origin) is correctly stating the point made at 2.9.1 (Acquisition of domicile of choice by dual resident).
(2) *Loss of domicile of choice.* There are two ways to "lose" a domicile of choice:
    (a) by acquiring a new domicile of choice;
    (b) by abandonment without acquiring a new domicile of choice.

The judge here is considering acquisition of a new domicile of choice.[18] The passage (so far as it relates to a domicile of choice replaced by a new domicile of choice) correctly states the point made at 2.9.1 (Acquisition of domicile of choice by dual resident) above.

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

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

This is consistent with the test of acquisition of domicile: see 2.9.1 (Acquisition of domicile of choice by dual resident).

2.9.3 *Which is the "chief" residence?*

The next question is exactly how one ascertains which of two competing residences is the chief one. There is helpful guidance in *Plummer v IRC* 60 TC 452. Here, Miss Plummer had a domicile of origin in England.

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

She intended to live in Guernsey, but was studying at university in London, so she spent only some weekends and holidays in Guernsey. In all, two-thirds of her time was spent in England and one-third in Guernsey. It was held that England remained her chief residence but the test was not just a matter of counting the days:

> [Counsel for the taxpayer] submitted that the commissioners paid no regard to anything except the relative amounts of time which the taxpayer spent in England and Guernsey during the years in question. They ignored the quality of her presence in each country: the fact that she was in England solely for the purpose of education and in Guernsey because it was her family home. I do not think that this is a fair reading of the commissioners' decision. They set out at length the taxpayer's ties with Guernsey and her reasons for remaining in England. In deciding whether the house in St. Peter Port had become her chief residence, they said:
>
> > "We accept the [taxpayer's] evidence that she likes Guernsey and enjoys the amenities of the island when she is there, quite apart from enjoying the company of her family ... We do not underestimate the part which Guernsey plays in her thinking.."
>
> Nevertheless they said that these considerations did not outweigh the fact that the taxpayer had resided for the greater part of the year in England and that there had been no "break in the pattern" which would justify a finding that she had ceased to have her chief residence in England. She had not, to use the language of Lord Hatherley in *Udny v Udny*, LR 1 Sc & Div 441, settled in Guernsey.
>
> I think that this was a conclusion to which the commissioners were on the evidence entitled to come. I go further and say that in my judgment it was the right conclusion. If the taxpayer had in 1980 broken altogether with England and settled in Guernsey like her mother and sister and then, even after a relatively short interval, returned to England for study, the quality of her presence here might have been such as to prevent a revival of her domicile of origin. But the fact is that she has not yet settled in Guernsey, and the reasons why she has been unable to do so are in my view irrelevant. When there is no competing place of continuing residence, settlement may be established by presence for a very short time; even for a single day. But an inference of settlement from a short stay is difficult to draw when the person in question divides his physical presence between two countries at a time. To treat the house in Guernsey as her chief residence simply because it is the sole

> residence of her mother and sister would in my view be attributing to her a kind of quasi-dependent domicile for which there is no legal justification. And the fact that the taxpayer may intend to settle in Guernsey after her education and training are completed and then to remain permanently is not sufficient to give her a proleptic domicile of choice.[19]

2.10 Presence in UK because of illness

In *Moorhouse v Lord*, Lord Kingsdown said:

> Take the case of a man labouring under a mortal disease. He is informed by his physicians that his life may be prolonged for a few months by a change to a warmer climate and that at all events his sufferings may be mitigated by such a change. Is it to be said that if he goes out to Madeira he cannot do that without losing his character as an English subject, without losing his right to the intervention of the English laws as to the transmission of property after his death, and the construction of his testamentary instruments. My lords, I apprehend that such a proposition is revolting to common sense, and the common feelings of humanity.[20]

Someone who comes to or stays in the UK for medical treatment will not become domiciled here. This is so even if the individual comes or stays for treatment of a final illness and knows that he will not recover to return home. This is so even if the individual has a UK domicile of origin, acquires a foreign domicile of choice, and returns here only for medical treatment.

However, that applies only to one who stays here purely for medical

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19 Likewise *Barlow Clowes International v Henwood* [2008] EWCA Civ 577 at [104]:

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

20 (1863) 10 HLC 272 at 292. In *Udny v Udny* (1869) 1 LR Sc & Div 441, Lord Westbury said at 458:

> "There must be a residence freely chosen, and not prescribed or dictated by any external necessity, such as ... the relief from illness ..."

treatment or palliative care.[21] If, say, an individual comes to England who is housebound and needs long-term care, or because the weather in Bournemouth is better for his health than Falkirk,[22] the individual may acquire an English domicile; it depends of course on intention in each case.

2.11 Domicile and citizenship

2.11.1 *Retention of foreign citizenship*

In *IRC v Bullock*, the court said:

> Domicile is distinct from citizenship. The fact that the taxpayer chose to retain his Canadian citizenship and not to acquire UK citizenship would not be inconsistent with his having acquired a domicile in the UK, but his adherence to his Canadian citizenship is, in my opinion, one of the circumstances properly to be taken into consideration in deciding whether he acquired a UK domicile.[23]

2.11.2 *Acquisition of UK citizenship*

An individual who wishes to become a British citizen must usually sign a declaration that he intends to reside in the UK. Naturalisation does not, however, carry with it the inevitable consequence of a change of domicile: see *Wahl v IRC* (1932) 147 LT 382. Naturalisation is merely one factor to be taken into account, but it is a powerful one: compare *Steiner v IRC* 49 TC 13.

HMRC in practice accept that a naturalised citizen may retain a foreign domicile.[24] However, the foreign domiciliary who applies for UK citizenship would be well advised to consider his domicile position, and it may be appropriate to take other steps to manifest his ultimate intention to return home in due course.

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

22 As in *Reddington v MacInnes* [2002] ScotCS 46 accessible *www.bailii.org*.

23 51 TC 522 at 540.

24 FWIW *Al Fayed v Advocate General* [2002] STC 910, para 23 records the HMRC view in 1985 that UK citizenship would have no effect on Mr Fayed's domicile.

2.12 Refugees, illegal immigrants and temporary visas

A refugee may be forced to sever most of his links with his country of origin. But while that may show he had no intention to return to his country of origin, it would not, by itself, show that he had acquired an intention to reside in the UK permanently.

A person in a country illegally may become domiciled there, though the illegality is a factor in deciding whether he has a genuine intention of remaining there.[25]

In *Barlow Clowes International v Henwood*:

> He was not able to live there on a permanent basis without the permission of the Mauritian government. His residence was ... in that sense precarious. This does not make it impossible for him to acquire a domicile of choice in Mauritius but makes it less likely that he did so.[26]

2.13 Married women

2.13.1 *Marriage after 1 January 1974*

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

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

Although a wife does not automatically acquire the domicile of her husband, the decision to marry a UK domiciliary and set up a home in the UK may be evidence of an intention to reside in the UK permanently, but

25 *Mark v Mark* [2006] AC 98.
26 [2008] EWCA Civ 577 at [119].

of course that depends on all the facts.[27]

2.13.2 *Marriage existing on 1 January 1974*

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

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

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

In Ireland the domicile of dependency rule was held unconstitutional[28] and it is an interesting question whether the English transitional provision is consistent with the Human Rights Act 1998. In practice the issue may never arise.

2.13.3 *Marriage ended before 1 January 1974*

In *Re Wallach* [1950] All ER 199, a widow died five days after the death of her husband. The judge held that a married woman retained her domicile of dependency when the marriage ceased, unless and until she changed it (by abandonment or by acquisition of a new domicile of choice).

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27 This is obvious but if authority is needed, see *Cyganik v Agulian* 8 ITELR 762 at [46]. Likewise the fact that T's spouse is UK resident may tend to suggest that T has not acquired a foreign domicile of choice; see (if authority is needed) *Gaines-Cooper v HMRC* [2007] STC (SCD) 23.

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

It has been said that the test for abandonment of a domicile of dependency is more lenient than the test for abandonment of a domicile of choice.[29] However, it is submitted that the *test* is the same: the individual must (1) cease to reside in the place of domicile of dependency and (2) cease to intend to reside there permanently. However, in the case of a domicile of dependency the individual may never have intended to reside there permanently, so requirement (2) may in practice be easier to satisfy. The test is more lenient in that the onus of proof is more easily satisfied.

2.13.4 *Woman a US national*

The US/UK Treaty[30] reverses the domicile of dependancy for US nationals. Article 4(6) of the treaty provides:

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

As far as I am aware, the US Treaty is the only one which does this.

2.14 Children

The domicile of children during their minority is not usually important, but there is a lengthy discussion in RDRM, not printed here for reasons of space.

2.15 Ireland/Northern Ireland

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

> For the purpose of determining the domicile of any person, Northern

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

30 Convention of 24 July 2001, SI 2002/2848. The USA IHT DTT does not contain the same rule.

Ireland shall be deemed always to have been a separate part of the UK.

2.16 HMRC rulings on domicile

The FA 2008 repealed ss.42 and 43 ITEPA and s.9(2) TCGA which provided a ruling procedure for ordinary residence and domicile. Ordinary assessment and appeal procedures now apply. This was a sensible reform, which had been advocated in earlier editions of this work.

HMRC Brief 17/09 provides:

> **Initial non-domicile claims – Form DOM 1**
> Tax Bulletin 29, published in June 1997, announced that following the introduction of self assessment HMRC (the former Inland Revenue) would no longer provide a residence rulings service. However we continued to accept initial non–domicile claims on forms DOM 1 or P86. Enquiries are sometimes undertaken into such claims under Schedule 1A TMA 1970. In addition an enquiry under section 9A TMA 1970 can also be made into a claim to non-domicile status made on a Self Assessment tax return either as a stand alone enquiry or as part of a wider enquiry.
> The publication of our new guidance on domicile, plus the fact that from 2008-09 onwards a claim to the remittance basis is no longer mandatory, and must be made on a year by year basis where an individual has unremitted foreign income or gains of £2,000 or more arising in the tax year, mean that HMRC will no longer accept initial non-domicile claims on form DOM 1 or form P86. Form DOM 1 is being withdrawn completely. It will be replaced by the new comprehensive domicile guidance mentioned above that will allow the vast majority of people to self assess their own domicile status. Form P86 will also be withdrawn soon and replaced by a new form. Until such time as the new form is issued individuals do not need to fill in boxes 12 to 17 on the P86 when submitting it. If they choose to fill in those boxes HMRC will ignore the content when processing the form.
> Any DOM 1 forms received by HMRC by close of business 25 March 2009 will still be processed but any received after that date will be returned unexamined. In future, subject to the comments below about Inheritance Tax, enquiries about domicile status will be dealt with by way of an enquiry into a Self Assessment tax return which an individual has made on the basis that they are not domiciled in the UK.
> Where an individual has already submitted a form DOM 1 or P86 and obtained an initial view from HMRC about their domicile status it will be unusual for us to open an enquiry into domicile status in the few years after that, unless new information becomes available that indicates our initial view was incorrect or there has been a change in circumstances. However with the passage of time, circumstances and intentions change and so that initial view from HMRC can become less and less useful as an indicator of domicile status. For example if an individual had advised HMRC on their arrival in England a decade or so ago that

they planned to leave the UK after five years but had since married, had a family and decided to make England their permanent home then they will have adopted a domicile of choice within the UK.

Domicile and Inheritance Tax

Where an individual who is not domiciled in the UK settles non-UK assets into a non-UK resident trust then assets in that trust will not be subject to inheritance tax. Following the release of the new HMRC guidance on domicile most settlors should now be able to decide for themselves whether or not they are UK domiciled.

An individual setting up a non-resident trust who, having taken account of the new HMRC guidance, considers they are non-UK domiciled is not obliged to submit an Inheritance Tax account to HMRC. If the settlor is non-UK domiciled then no Inheritance Tax is due. But if an Inheritance Tax account is submitted in these circumstances, HMRC will continue its existing practice and only open an enquiry into that return if the amounts of Inheritance Tax at stake make such an enquiry cost effective to carry out. At present that limit is £10,000.

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

Enquiries into domicile status

For 2008-09 and later years, in order to make a valid claim to the remittance basis individuals will be required to state on their Self Assessment tax return the grounds for their entitlement by stating either that they are not domiciled in the UK or that they are not ordinarily resident in the UK (or both). The new domicile guidance will help individuals decide their domicile status, supported as appropriate by any professional advice they may obtain. As a result, if HMRC decides to enquire into an individual's domicile status this will be by way of a section 9A TMA enquiry into their Self Assessment tax return. (Alternatively in appropriate cases HMRC may enquire into an individual's domicile status by way of a Part VIII IHTA enquiry into an Inheritance Tax return.) Where a claim to the remittance basis is not challenged for that year it does not mean HMRC necessarily accepts the individual's domicile is outside the UK and does not prevent HMRC from later opening an enquiry to consider the domicile status of the individual in relation to that, or any earlier year.

Enquiries aimed at establishing an individual's domicile are, by their very nature, examinations of an individual's background, lifestyle, habits and intentions, possibly over the course of a lifetime. Consequently, any such enquiries conducted by HMRC will, where necessary, extend to areas of individuals' and their families' affairs that may not normally be regarded as relevant to their UK tax position. As a result of some feedback from customers on such domicile enquiries our new domicile guidance includes a section starting at paragraph

> 49600 which explains the nature of a domicile enquiry and the sorts of questions an individual will need to answer as part of that enquiry.
> Where HMRC has expressed a view on an individual's domicile status for income tax or capital gains tax purposes, as a result of an enquiry, then that view will also apply for Inheritance Tax purposes at that time. Likewise a HMRC view expressed for Inheritance Tax purposes, following a Part VIII IHTA enquiry, will also apply for income tax and capital gains purposes at that time. However, it is important to remember that each decision on domicile will be made at a certain point in time, if circumstances have changed since the time of the relevant decision, the domicile of the taxpayer may also have changed.

2.16.1 *Obtaining an HMRC ruling on domicile*

In order to obtain a ruling, an individual should transfer foreign property to a settlement. The value transferred must be sufficient to give rise to tax of £10,000 (on the assumption of UK domicile) after allowing for the nil rate band and available exemptions.

2.17 Domicile of company

The domicile of a company is where it is registered, which is the place of incorporation.[31] Domicile of a company is only rarely significant for tax or any other purpose.

31 *Gasque v IRC* 23 TC 209; Dicey & Morris *Conflict of Laws*, 14th ed, para 30-002.

CHAPTER THREE

RESIDENCE OF INDIVIDUALS

3.1 Why do residence and ordinary residence matter?

Residence is fundamental to the territorial limitations of income tax and CGT. It is not possible to give a full list but the most important are:

(1) The charge to income tax on foreign income of UK residents.
(2) The exemption for certain UK source income of non-residents.
(3) Capital gains tax.[1]

Ordinary residence does not matter as much as residence. The main differences (all advantages) for an individual who is resident but not ordinarily resident in the UK (compared to one who is resident *and* ordinarily resident) are as follows:

(1) The transfer of assets abroad provisions do not apply.[2]
(2) Different employment income rules apply.[3]
(3) The RFI remittance basis applies even if UK domiciled.[4]
(4) Different NIC rules apply.[5]
(5) Exempt gilts qualify for their IT and IHT exemptions.[6]

Residence is also important for non-tax purposes, such as jurisdiction.

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1 See 11.1 (Savings and investment income), 12.1 (Employment income), 31.1 (Limitation on liability for non-residents) and 31.1 (Capital gains tax on individuals).
2 See 16.11 (Transfer of assets abroad: introduction).
3 See 12.1 (Employment income).
4 See 9.5 (Who qualifies for the remittance basis?).
5 See 35.5 (ROW: employed in GB); 35.6 (ROW: residence requirements).
6 See 44.4 (Non-settled property: exempt gilts).

This chapter considers residence of individuals: see too 4.1 (Residence of trustees); 26.5 (Residence of partnership); 3.35 (Residence of companies); 56.4 (Residence and domicile of PRs for CGT) and 57.2 (Residence of PRs for IT).

3.2 The concepts of residence and ordinary residence

3.2.1 *Residence is a status*

The concept of "residence" is distinct from physical presence. A person may be UK resident at a time when not present in the UK (e.g. if absent on a day trip abroad). A person may be present in the UK without being UK resident. Residence is a legal status; contrast physical presence, which is not a status, just a simple physical fact.

3.2.2 *Residence during part of tax year*

The concept of "residence" is used in tax statutes in three slightly different ways:

(1) Sometimes it is used to describe a status which one has (or does not have) at a particular moment of time.[7]
(2) Sometimes it is used to describe a status which one has (or does not have) during a period of time which does not coincide with a tax year.[8]
(3) Sometimes it is used to describe a status which one must have (or not have) specifically for the period of a tax year. Under this usage one could not cease to be resident during a tax year: residence could only

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7 For a non-tax statute example, see s.4(1) Representation of the People Act 1983:

> "A person is entitled to be registered in the register of parliamentary electors for any constituency ... if *on the relevant date* he (a) is resident in the constituency ...".

For a tax example see s.13 TCGA; see 6.16.1 (Section 13).

8 For a non-tax statute example see s.4(2) Representation of the People Act 1983:

> "A person is not entitled to be registered in the register of parliamentary electors for any constituency in Northern Ireland unless, in addition to complying with subsection (1) above, he has been resident in Northern Ireland *during the whole of the period of three months ending on the relevant date*."

change at the beginning or end of a tax year.[9]

If it matters (in practice the issue does not often raise difficulties) the context must determine which sense is meant. It is important, to avoid confusion, to realise that either sense is a possible one.

Sometimes the context makes it clear, e.g:

(1) Section 13 TCGA applies if a person is resident at the time when the gain accrues to the company.
(2) Section 2 TCGA ("a person shall be chargeable to CGT in respect of chargeable gains accruing to him in a year of assessment during any *part* of which he is resident in the UK...). This clearly assumes that residence is a status which one has (or does not have) during a part of a tax year.[10]

Sometimes the context provides at least an inference, e.g. the CGT exit charge (which applies when the taxpayer ceases to be UK resident) applies at the time that the individual actually leaves, not at the end of the tax year.[11]

In income tax, it is generally assumed that residence is a status which one has (or does not have) for an entire tax year[12] and so the IT exit charge on a trader who ceases to be UK resident applies at the end of the tax year of emigration.[13] This is sometimes expressed by saying that one is resident "for a year of assessment" (the language used in ESC A11). But for even

9 Sir John Donaldson MR drew this distinction in *Gubay v Kington* [1983] STC 443 at p. 451 but the terminology he proposed (status v. factual residence) is not ideal since residence during part of a year is a matter of status as much as residence during the whole of a year.

10 See *Smallwood v HMRC* [2009] STC 1222 at [31]:

> "The UK tax provisions set out above create certain tax consequences for gains in a given year if [taxpayers] are resident here for part of the year. Where they apply, residence in part of the year gives rise to a charge to tax on gains made in another part of the year, but they do not do so by deeming the residence to be for any period longer than the actual period of residence. They do so simply by defining the gains by reference to the period in which they arise."

11 See 6.2 (Clawback of holdover relief on emigration of individual), 6.4 (Exit charge for trusts), 6.6 (Migration of individual trader) and 5.19 (Exit charge for trusts); presumably the usage of s. 2 TCGA applies generally for CGT.

12 See 6.2 (Income tax on individuals).

13 See 7.6 (Migration of trader).

for income tax, the point depends on the context. For instance, when ESC A11 refers to "the period of residence here during the year" it is obviously using the word "residence" to describe a status which changes during a tax year.

3.2.3 *Ordinary residence during part of tax year*

Ordinary residence, like residence, is also a legal status. Once again, the expression could be used in two different ways:

(1) to describe a status which one has (or does not have) at a particular moment of time, or during a period of time which need not coincide with a tax year.
(2) describe a status which one must have (or not have) specifically for a tax year. Under this usage one could not cease to be ordinarily resident during a tax year. Ordinary residence could only change at the beginning or end of a tax year.

But usage (1) is the normal meaning, and usage (2) would require a clear context to make it apply. It is suggested that references to "ordinary residence", in an income tax or CGT context, are (at least normally) references to a status which may change during a tax year, it is not a status which has to last an entire tax year.

3.2.4 *The source of the concepts*

Given the centrality of the concept, it is surprising that there is nothing like a definition of "residence" in the legislation. Several statutory provisions impinge on the subject and residence has been discussed in a number of decisions by the courts. HMRC 6 is also important, supplemented by other HMRC statements.

There is no statutory guidance on the meaning of "ordinary residence". Like simple residence, the meaning has been discussed in the case law but HMRC 6 is more important in practice.

This chapter first considers the statutory provisions, then the case law and then HMRC 6.

We need terminology for the statutory rules (for which statute does not provide a label) and I coin the following terms:

Temporary UK purpose rule: s.831(1)(2)(3) ITA
183-day rule: s.831(4)(5) ITA
Occasional residence abroad rule: s.829 ITA.

I refer to the three rules together as **"the statutory residence rules"**.

3.3 Temporary UK purpose and 183-day rules

3.3.1 *Temporary UK purpose rule*

Section 831(1) ITA provides:

> Subsection (2) applies in relation to an individual if—
> (a) the individual is in the UK
> [i] for some temporary purpose only and
> [ii] with no view[14] to establishing the individual's residence in the UK, and
> (b) during the tax year in question the individual spends (in total) less than 183 days in the UK...[15]

If these conditions are satisfied, one turns to s.831(2):

> Apply the following rules in determining the individual's liability for income tax.

Two rules now follow:

> *Rule 1*
> In relation to pension or social security income arising from a source outside the UK, treat the individual as non-UK resident for the purposes of the following ...

Rule 1 goes on to specify an exotic set of categories of income in

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14 ITA EN para 2477 states:
"Subsection (1)(a) refers only to 'view' and omits reference to 'intent' on the basis that 'view' is wider than 'intent' or 'intention'."
But it is considered that these words both all mean the same thing.

15 A further paragraph follows: "In determining whether an individual is within para (a) ignore any living accommodation available in the UK for the individual's use." I deal with this paragraph at 3.6 (Accommodation in the UK).

inordinate detail.[16]

> *Rule 2*
> In relation to income arising from a source outside the UK, treat the individual as non-UK resident for the purposes of any charge under a provision mentioned in section 830(2) of ITTOIA 2005 (which contains a list of provisions under which relevant foreign income is charged).[17]

The two rules have the same effect (in relation to the income to which they apply): they treat the individual as non-resident for certain purposes. I refer to them together as "**the temporary UK purpose rule**". That label does not quite correctly summarise the conditions of s.831(1), no label could do so.

The rule is vague because of the word "temporary". The words in s.831(1)(a)[ii] ("and with no view to establishing the individual's residence in the UK") should, I suggest, be regarded as a paraphrase or explanation of "for some temporary purpose only". The additional words do not clarify the matter at all. A definition or explanation of residence

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16 "(a) Chapter 4 of Part 9 of ITEPA 2003 (tax on foreign pensions),
(b) Chapter 5A of that Part (tax on pensions under registered pension schemes) but only if the income is an annuity under a registered pension scheme within para 1(1)(f) of Schedule 36 to FA 2004,
(c) Chapter 10 of that Part (tax on employment-related annuities),
(d) Chapter 15 of that Part (tax on voluntary annual payments),
(e) section 647 of ITEPA 2003 (meaning of 'foreign residence condition') but only in its application for the purposes of section 651 of that Act (which provides an exemption for tax under Chapter 14 of Part 9 of that Act), and
(f) Chapter 6 of Part 10 of ITEPA 2003 (taxable foreign benefits).
See sections 566 and 657 of ITEPA 2003 for the definitions of 'pension income' and 'social security income'."
For completeness, s.831(3) ITA provides:
"Para (e) of Rule 1 in subsection (2) applies only if—
(a) the individual makes a claim as mentioned in section 647(3)(a) of ITEPA 2003, and
(b) the Commissioners are satisfied that subsection (2) of this section applies in relation to the individual."
But all this is academic as the application of rule 1 never makes any difference in practice.

17 For completeness, the rule adds: "In this rule 'income' does not include income chargeable as a result of section 844 of ITTOIA 2005 (unremittable income: income charged on withdrawal of relief after source ceases)." But this is also academic.

cannot be helpful if it uses the word “residence” without explanation, as happens here.

The rule, however vague, is consistent with the natural meaning of residence since someone in the UK for a merely temporary purpose (whatever that means) would not be said to be resident in the ordinary sense (whatever that is.)

Section 832 ITA provides the identical rule (set out in full) for the purposes of Chapters 4 and 5 Part 2 ITEPA (employment income). Note that the temporary UK purpose rule only applies for certain income tax purposes, and the question of residence may arise for other income tax purposes.[18]

3.3.2 *183-day rule*

Section 831(4) ITA provides:

> Subsection (5) applies in relation to an individual if subsection (2) would have applied in relation to the individual but for subsection (1)(b).

This convoluted wording is rather more difficult to follow now it is rewritten in plain English than it was before 2007. The reader who patiently works through the labyrinth will conclude that subsection (5) applies if:

> (a) the individual is in the UK
>   [i] for some temporary purpose only and
>   [ii] with no view to establishing the individual's residence in the UK, and
> (b) in the tax year in question the individual spends in total 183 or more days in the UK.

If these conditions are satisfied, one turns to subsection (5):

> Apply the rules set out in subsection (2) in determining the individual’s liability for income tax.

18 For instance, residence may be relevant for the purpose of non-residents income tax relief; see 31.1 (Non-residents income tax relief).

But—
(a) instead of treating the individual as non-UK resident in relation to the income and for the purposes mentioned in those rules, treat the individual as UK resident, and
(b) ignore subsection (3).

Amended as subsection (5) requires, the rules in subsection (2) are:

Rule 1
In relation to pension or social security income arising from a source outside the UK, treat the individual as UK resident for the purposes of the following ... [the list is set out in the footnote above].

Rule 2
In relation to income arising from a source outside the UK, treat the individual as UK resident for the purposes of any charge under a provision mentioned in section 830(2) of ITTOIA 2005.

The two rules have the same effect (in relation to the income to which they apply): they treat the individual as UK resident for certain purposes. I refer to this as "**the 183-day rule**", though once again, that label does not quite correctly summarise the conditions of s. 831(4).

The rule is relatively precise, since it is easy to count the 183 days. It is also consistent with the natural meaning of residence since someone who spends 183 days in the UK can in the normal sense of the word be said to be resident here for the year. Like the temporary UK purpose rule, it is extended for (some) employment income purposes by s.832 ITA, but it applies only for certain IT purposes.

3.3.3 *Temporary purpose and 183-day rules: comments*

The two rules only cover some of the possible permutations of fact:

Name of rule	Temporary UK purpose	183 UK days	Resident
Temporary UK purpose rule	Yes	No	No
183-day rule	Yes	Yes	Yes

What if a person is *not* in the UK for a temporary purpose? The section is silent. Presumably such a person:

(1) is in the UK for a permanent purpose, in which case he is resident; or
(2) is not in the UK at all (or in the UK, but not for any purpose?) in which case he is not resident.

3.4 Occasional residence abroad rule

Section 829 ITA provides:

> **Residence of individuals temporarily abroad**
> (1) This section applies if—
> (a) an individual has left the UK for the purpose only of occasional residence abroad, and
> (b) at the time of leaving the individual was both UK resident and ordinarily UK resident.
> (2) Treat the individual as UK resident for the purpose of determining the individual's liability for income tax for any tax year during the whole or a part of which the individual remains outside the UK for the purpose only of occasional residence abroad.

I call this the "**occasional residence abroad rule**".

This is reworded from the earlier provision in ICTA, removing several puzzling features. The problem remains that "occasional residence abroad" is hopelessly vague in the modern world. But the rule, however vague, is consistent with the natural meaning of "residence" since someone leaving for occasional residence abroad (whatever that is) would not be said to be UK resident in the ordinary sense (whatever that is).

In addition, the occasional residence abroad rule only covers one of several possible permutations of fact. What if the individual has left the UK for the purpose of occasional residence abroad (whatever that means) and before he left he was resident and not ordinarily resident, or he was not resident at all? The statute is silent. But presumably the individual would be regarded as non-resident.

This rule applies "for the purpose of determining the individual's liability for income tax". If one can identify other purposes (collection of tax, for instance) the rule would not apply to it.

3.5 Relationship between statutory residence rules and natural meaning of "residence"

If the temporary UK purpose rule applies, the individual is treated as non UK resident (for certain IT purposes). If the 183-day rule applies, the individual is treated as UK resident (for certain IT purposes). If the occasional residence abroad rule applies, the individual is treated as UK resident for the purposes of determining the individual's liability for IT (but not for other purposes, such as rules relating to collection of tax.) the statutory residence rules are also irrelevant for ordinary residence. If this is read literally, it creates an absurdly complicated situation. There are at least three classes of individual:

		Statutory rule			**Status**	
Case no	UK resident (general meaning)	Temporary UK purpose	183 days in UK	Occasional residence abroad	Status for most IT purposes	Status for other IT purposes
1	Y	Y	N		Non-resident	Resident
2	N		Y		Resident	Non-resident
3	N			Y	Resident	Non-resident

The only solution to this problem is to downplay the importance of the statutory residence rules.. One could say that the statutory rules only state what would in any event be the normal meaning of residence. Then the statutory rules are otiose. One could say that the section should be regarded as laying down rules which apply for income tax generally. Then the enormously detailed list in s.831(2) specifying types of income which are affected is unnecessary and inappropriate. This is the lesser of two evils, and HMRC agree. Inspectors Manual para 43 provided:

> In practice, however, ICTA, s 336 [now s.831 ITA] is applied to other Schedules and cases as its language has an "illustrative value" (see Rowlatt, J, in *Lysaght v CIR* 13 TC 511 at 515) on all questions of residence.

Thus no distinction is drawn between residence for IT purposes and residence for NIC purposes even though NIC has no equivalent statutory provisions.

If that is right, the High Court was wrong (or at least wasting its time) in *Grace* to consider separately what it termed "common law residence" (ie "residence" in its ordinary meaning) and then the statutory residence rules, as if they were separate and independent sets of rules. ITA EN was nearer the mark:

> In his judgment in *Reed v Clark*, 58 TC 528, Nicholls J reviews the history of this provision ... and the cases in which it is considered. He observes (at page 550 B):
>
>> Despite the long history of the statutory provision now reproduced as s 49, the researches of very experienced Counsel have not revealed any reported decision in which a claim to tax has succeeded only by virtue of that provision.…

There was no case where the statutory rules mattered between the inception of income tax and *Reed v Clark* in 1985, as far as I am aware there has been no case since then, and it seems safe to say that such a case will never be.

3.6 Accommodation in the UK

3.6.1 *The supposed available accommodation rule*

It was formerly the official HMRC view that:

> Individuals are regarded as resident in the UK for tax purposes for a year, if they have accommodation available for their use and are present here at any time in the year.[19]

This is called "the available accommodation rule". John Avery Jones states tactfully that "it is difficult to see how the available accommodation rule

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19 Press Release 16 March 1993 [1993] STI 468. Likewise IR20 (1983 version) para 14:

> If you go abroad permanently but have accommodation available for your use in the UK, you will be treated as resident here for any tax year in which you visit the UK. The length of the visit does not matter. ...
> A visitor who has accommodation available here will be regarded as resident for any year in which he comes to the UK, however short his visit may be...

ever arose".[20] More bluntly, the rule did not exist.[21] The rule was abolished by statute, in two stages.

3.6.2 *Full-time workers abroad*

From 1956, the supposed rule was abolished for those who worked full-time abroad. Section 830 ITA provides:

> **Residence of individuals working abroad**
> (1) This section applies for income tax purposes if an individual works full-time in one or both of—
> (a) a foreign trade, and
> (b) a foreign employment.
> (2) In determining whether the individual is UK resident ignore any living accommodation available in the UK for the individual's use.

Section 830 then elucidates the terms used in subsection (1):

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20 [1993] BTR 286.

21 The rule was inconsistent with the case law: see 3.8 (Case law on residence). In *Gaines-Cooper v HMRC* [2007] STC (SCD) 23 at [165] the Special Commissioners rightly said:

> "In general availability of accommodation is *a factor to be borne in mind* in deciding if a person is resident here ...".

The rule was expressly rejected in *High Tech International v Deripaska* [2006] EWHC 3276 [2007] EMLR 15 at [25]; *Cherney v Deripaska* [2007] EWHC 965 (Com) [2007] ILR 49 at [45]; and *Yugraneft v Abromovich* [2008] EWHC 2613 (Comm) at [487] "Purchases of expensive property in England which, in the case of a man of ordinary wealth, would suggest settlement here, may have no such significance to someone for whom money is no object. Mr Abramovich's use of the Lowndes Square property ... does not indicate that ... it was his usual or settled place of abode. It was not then the place in which, even for limited periods, he habitually and normally resided for a settled purpose. It was a place to which he came when visiting London...".

How, then, did HMRC ever come to hold that the rule existed? I guess that the origins of the rule goes back to the late 19th or early 20th century, before home ownership became widespread. In those days the purchase of accommodation was an unusual and significant commitment, for the usual course was to rent or stay in a hotel, so it might be more reasonable to regard anyone who made that commitment as UK resident. The change of home ownership patterns later made the rule a wholly inappropriate test for residence, but HMRC continued to propound it even after its rationale disappeared and was forgotten.

(3) A trade is foreign if no part of it is carried on in the UK.
(4) An employment is foreign if all of its duties are performed outside the UK.
(5) An employment is also foreign if in the tax year in question—
(a) the duties of the employment are in substance performed outside the UK, and
(b) the only duties of the employment performed in the UK are duties which are merely incidental to the duties of the employment performed outside the UK in the year.
(6) In this section—
"employment" includes an office, and
"trade" includes profession and vocation.[22]

This requires a total disregard of available accommodation. It disapplies the available accommodation rule and disregards the accommodation for all purposes.

3.6.3 *Partial disregard of accommodation*

In 1993 this disregard was extended. The drafting is opaque. Section 831(1)[A] ITA sets out the temporary UK purpose rule, discussed above:

[A] Subsection (2) applies in relation to an individual if—
(a) the individual is in the UK for some temporary purpose only and with no view to establishing the individual's residence in the UK, and
(b) in the tax year in question the individual spends (in total) less than 183 days in the UK.

This is then qualified by s.831(1)[B]:

[B] In determining whether an individual is within para (a) ignore any living accommodation available in the UK for the individual's use.

So one disregards available accommodation for the temporary UK purpose rule. But one does have regard to it for other purposes.[23] One purpose

22 This uses terminology discussed elsewhere: if s.830(2) mattered, see 12.5 (Where are duties performed: incidental duties); and 3.15.1 (Meaning of "work full-time abroad").
23 Except for full-time workers abroad.

where one has regard to it is the occasional residence abroad rule.[24] Perhaps there are others. If this book is right that the temporary UK purpose rule is in fact of nil or negligible importance, this was not the right way for Parliament to go about making the desired reform.

HMRC 6 para 1.5.22 provides:

> You should always look at the pattern of your lifestyle when deciding whether you are resident in the UK. Things you should consider would include what connections you have to the UK such as family, *property,* business and social connections. Just because you leave the UK to live or work abroad does not necessarily prove that you are no longer resident here if, for example, you keep connections in the UK such as property, economic interests, *available accommodation,* and social activities or if you have children in education here.

This is consistent with s.831(1)[B] ITA because the statutory disregard applies for the temporary UK purpose rule and not the occasional residence abroad rule. However, the former available accommodation rule has been quietly abandoned: it is no longer suggested that one day's presence and accommodation is sufficient to amount to UK residence.[25]

3.7 CGT statutory residence rules

Section 9(1) TCGA provides:

> In this Act "resident" and "ordinarily resident" have the same meanings as in the Income Tax Acts.

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24 This was HMRC's intention when enacting the original legislation. Press Release [1993] STI 468 para 5:

> "Similarly, where an individual leaves the UK, the retention of a home here will continue to be a factor in considering whether he or she has left the UK permanently."

See too John Avery Jones [1993] BTR 286 and Philip Baker OTPR Vol 3 p.143.

25 See 3.26 (Longer-term visitors practice). This was HMRC's intention when enacting the legislation. Press Release [1993] STI 468 para 5:

> "There will be no change in the practice of treating as resident and ordinarily resident an individual who comes to and remains in the UK where he or she owns or acquires on a lease of 3 years or more accommodation in this country."

See too John Avery Jones [1993] BTR 286 and Philip Baker OTPR Vol 3 p.143.

The drafter was understandably unsure whether this would incorporate the 183-day and temporary UK purpose rules which (supposedly) apply only to some types of income, so s.9(3)(4) TCGA provides CGT rules to the same effect:

> (3) Subject to sections 10(1) and 10A, an individual who is in the UK for some temporary purpose only and not with any view or intent to establish his residence in the UK shall be charged[26] to capital gains tax on chargeable gains accruing in any year of assessment if and only if the individual spends (in total) at least 183 days in the UK.
> (4) The question whether for the purposes of subsection (3) above an individual is in the UK for some temporary purpose only and not with any view or intent to establish his residence there shall be decided without regard to any living accommodation available in the UK for his use.

There is no express CGT equivalent for the IT occasional residence abroad rule, but that arguably is incorporated into CGT by s.9(1) TCGA.

3.8 Case law on residence

A person who does not meet the 183-day rule may still be resident here, but in what circumstances? Since the statutory provisions do not give a clear answer we turn next to the case law. The case law is quite considerable but does not help very much. The leading cases are *Levene v IRC* and *Lysaght v IRC* 13 TC 486 and 511. They reflect conditions of life in the 1920s. Viscount Cave said in 13 TC at 505:

> My Lords, the word "reside" is a familiar English word and is defined in the Oxford English Dictionary as meaning "to dwell permanently or for a considerable time, to have one's settled or usual abode, to live in or at a particular place". No doubt this definition must for present purposes be taken subject to any modification which may result from the terms of the Income Tax Act and Schedules; but, subject to that observation, it may be accepted as an accurate indication of the meaning of the word "reside".
> In most cases there is no difficulty in determining where a man has his settled or usual abode, and if that is ascertained he is not the less resident there because from time to time he leaves it for the purpose of business or

26 The IT rules use the word 'treated'; the CGT equivalent uses the word 'charged' but the end result is the same.

pleasure.

Of course these generalities do not take us very far. Viscount Cave then considered dual residence:

> But a man may reside in more than one place. Just as a man may have two homes – one in London and the other in the country – so he may have a home abroad and a home in the UK, and in that case he is held to reside in both places and to be chargeable with tax in this country. Thus, in *Cooper v Cadwalader* (5 TC 101) an American resident in New York who had taken a house in Scotland which was at any time available for his occupation, was held to be resident there, although in fact he had only occupied the house for two months during the year; and to the same effect is the case of *Loewenstein v de Salis* (10 TC 424).

Viscount Cave goes on to consider those who have no permanent home but live in hotels:

> The above cases are comparatively simple, but more difficult questions arise when the person sought to be charged has no home or establishment in any country but lives his life in hotels or at the houses of his friends. If such a man spends the whole of the year in hotels in the UK, then he is held to reside in this country; for it is not necessary for that purpose that he should continue to live in one place in this country but only that he should reside in the UK.
>
> But probably the most difficult case is that of a wanderer who, having no home in any country, spends a part only of his time in hotels in the UK and the remaining and greater part of his time in hotels abroad. In such cases the question is one of fact and degree, and must be determined on all the circumstances of the case (*Reid v IRC*, 10 TC 673). If for instance such a man is a foreigner who has never resided in this country, there may be great difficulty in holding that he is resident here. But if he is a British subject the Commissioners are entitled to take into account all the facts of the case.

To live permanently in hotels was, I think, not unusual in the 1920s. It does not happen much now, but nowadays a house may be "not in the nature of home but a substitute for hotels".[27]

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27 *Grace v HMRC* [2009] STC 213, Special Commissioners at [40]. This will need review when the decision is final.

The Special Commissioners summarise the case law with the following propositions:

> [1] the concept of residence is not defined in the legislation; the word therefore should be given its natural and ordinary meaning (*Levene*). The words "residence" and "to reside" mean "to dwell permanently or for a considerable time, to have one's settled or usual abode, to live in or at a particular place" (*Levene*).
> [2] the question whether a person is or is not resident in the UK is a question of fact for the Tax Tribunals (*Zorab*).
> [3] no duration is prescribed by statute[28] and it is necessary to take into account all the facts of the case; the duration of an individual's presence in the UK and the regularity and frequency of visits are facts to be taken into account;
> [4] also, birth, family and business ties, the nature of visits and the connections with this country, may all be relevant (*Zorab*; *Brown*).
> [5] in general the availability of living accommodation in the UK is a factor to be borne in mind in deciding if a person is resident here (*Cooper*) (although that is now subject to [s.831(1)[B] ITA]).[29]
> [6] the fact that an individual has a home elsewhere is of no consequence; a person may reside in two places but if one of those places is the UK he is chargeable to tax here (*Cooper* and *Levene*).
> [7] there is a difference between the case where a British subject has established residence in the UK and then has absences from it (*Levene*) and the case where a person has never been resident in the UK at all (*Zorab*).[30]

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28 Likewise *Reid v IRC* 10 TC 673 at p.678:

> "… the relation between a person and a place which is predicated by saying that a person 'resides' there includes inter alia the element of time, duration, or permanence, [but] that element – essential and important as it is – is not the sole criterion. … one of the parties maintained that the element of time was so important as to dwarf all the others into insignificance; but I think the Lord Advocate rightly contended that the facts of the relation between a person's life and the place in which part of it is spent may contain elements of quality, connected with the person's mode of life, and so on, which are equally relevant for consideration as the element of time, or the durability of the relation."

29 See 3.6 (Accommodation in the UK).

30 *Gaines-Cooper v HMRC* [2007] STC (SCD) 23 at [165]. The passage is an almost verbatim quote from *Shepherd v IRC* 78 TC 389 at [58] (Special Commissioner). The references are to *Levene v IRC* 13 TC 486; *IRC v Zorab* 11 TC 289; *Bayard Brown v Burt* 5 TC 667; *Cooper v Cadwalader* 5 TC 101.

These considerations are similar to that part of the OECD model treaty article on residence, under which an individual with a home in two states is deemed to be a resident of the state with which his personal and economic relations are closer (centre of vital interests); though this does not much help to resolve any practical issues of residence as that formula is itself somewhat imprecise.

Case law on "residence" in non-tax statutes is also relevant, so far as it applies the "ordinary" meaning of residence and follows the principles of *Levine*. There have been some recent jurisdiction cases in this category.[31]

3.8.1 *Case law: ordinary residence*

There are no statutory provisions, so a case law definition is all we have. The case law on ordinary residence is vague. "Ordinary residence" means:

> A man's abode in a particular place or country which he has adopted voluntarily and for settled purposes as part of the regular order of his life for the time being, whether of short or long duration.[32]

"Habitual residence" is a concept often used in non-tax legislation. If that term had a clear meaning, and if the concept was the same as "ordinary residence" then cases on habitual residence might be valuable. Unfortunately this line of enquiry leads nowhere. There is no clear definition of "habitual residence".[33] Although the House of Lords have stated that habitual residence and ordinary residence are interchangeable concepts,[34] the point was not fully argued. Some cases suggest that habitual residence is "something more than" ordinary residence,[35] though that "something more" is elusive. It has also been said that the concepts merely

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31 Under the Civil Jurisdiction and Judgments Order 2001 (SI 2001/3929) jurisdiction depends (in part) on residence. See *Yugraneft v Abromovich* [2008] EWHC 2613 (Comm) at [461]: "... the courts have sought to give the word [residence] the same 'ordinary' meaning in both tax cases (such as *Levene*) and jurisdiction cases (such as *Abbas*). It makes sense to do so. Resident for jurisdiction purposes but not resident for tax purposes is a distinction to be avoided if possible".

32 *R v Barnet LBC ex p. Shah* [1983] 2 AC 309 at p.343. This passage has often been cited with approval.

33 Habitual residence is a question of fact to be determined by the circumstances of each case: *Re M* [1993] 1 FLR 495.

34 *Mark v Mark* [2006] 1 AC 98 at [33].

35 *Cruse v Chittum* [1974] 2 All ER 940 at p.943.

share a "common core of meaning".[36]

3.8.2 *Critique of case law tests*

The case law is bluntly but accurately summarised by Malcolm Gunn:

> Residence is a question of fact. There are very few rules. Cases are decided as and when they arise, and without much reference to any other previous decision. The decisions might well conflict with each other but that's just tough luck and there is nothing anybody can do about it.[37]

This is recognised in other contexts. In *Sifton v Sifton* a beneficiary had an interest under a trust "so long as she shall continue to reside in Canada". The condition was void for uncertainty!

> The majority of the Court of Appeal have found themselves unable to give any more precise direction than that the appellant may leave Canada for a limited period and for a purely temporary purpose, without being able to define either the word "limited" or the word "temporary." … the questions propounded in the trustees notice of motion[38] do not at present

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36 *Nessa v Chief Adjudication Officer* [1999] 1WLR 1937 at p.1941.

37 *Taxation*, 3 December 1992, Vol 130, p.234. Lord Clyde made the same point in *Reid v IRC* 10 TC 673:

> "The expression 'resident in the United Kingdom' and the qualification of that expression implied in the word 'ordinarily' so resident are just about as wide and general and difficult to define with positive precision as any that could have been used. The result is to make the question of law become (as it were) so attenuated, and the field occupied by the questions of fact become so enlarged as to make it difficult to say that a decision arrived at by the Commissioners with respect to a particular state of facts held proved by them, is wrong."

38 The questions were:

"*(a)* In the event of Elizabeth maintaining a residence in Canada but temporarily going abroad (out of Canada) for the purpose of travelling and/or studying for a period not exceeding eleven months and returning to Canada thereafter, would Elizabeth during her temporary absence from Canada 'continue to reside in Canada' within the meaning of the words 'continue to reside in Canada' as used in said will?

(*b*) If the answer to question (*a*) be in the affirmative, could Elizabeth after a lapse of not less than one month again go abroad under similar circumstances and similarly 'continue to reside in Canada'?

(*c*) In the event that Elizabeth so temporarily goes abroad for a period of eleven admit of categorical answers. … But if the appellant's interest under the will is to be forfeited upon her "ceasing to reside in Canada," she has a right to have those questions categorically answered; and inasmuch as they cannot be so answered, the words, if constituting a condition subsequent, are void for uncertainty.[39]

3.9 Dual residence/dual ordinary residence

EIM para 42820 correctly states:

> An individual can be resident and ordinarily resident in more than one country at the same time. The fact that an individual might prove to be resident or ordinarily resident elsewhere does not mean that they will be neither resident nor ordinarily resident in the UK.

Likewise HMRC 6 para 2:

> **It is possible to be resident in the UK for income tax and capital gains tax purposes under our tax rules and at the same time be considered resident in another country under that country's rules.** This is called "dual residence".
> 3.2 ... You can be ordinarily resident in the UK and, at the same time, be ordinarily resident in another country. Your ordinary residence in another country does not prevent you being ordinarily resident in the UK.

This is soundly based on Lord Cave's comments: see 3.8 (Case law on residence).

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months should constitute a failure on her part to so 'continue to reside in Canada' may Elizabeth absent herself from Canada for any period under any circumstances and still so 'continue to reside in Canada' and if so, for what periods and under what circumstances may she so absent herself?

(*d*) Is the purpose for which Elizabeth absents herself from Canada material to the question of whether or not she so 'continues to reside in Canada'?

(*e*) If the answer to question (*d*) be in the affirmative
- I. Is any temporary purpose sufficient?
- II. If the answer to (*e*) be in the negative, what purposes would be sufficient?"

39 [1938] AC 656 at p.665.

3.10 Ordinary resident but not resident

A question arises whether an individual can be ordinarily resident in the UK but not resident. The natural meaning of the words suggests not, and *Levene* seems to confirm this:

> I find it difficult to imagine a case in which a man while not resident here is yet ordinarily resident here.[40]

However, the CGT legislation is clearly drafted on the basis that this is possible. Section 2(1) TCGA provides:

> ... a person shall be chargeable to CGT in respect of chargeable gains accruing to him in a year of assessment during any part of which he is resident in the UK, or during which he is ordinarily resident in the UK.

The drafter of these words (often copied into other contexts) clearly assumed it was possible to be ordinarily resident but not resident. This is supported by *Gaines-Cooper v HMRC*:

> 190. ...We are also of the view that the appellant would still be ordinarily resident in the UK even if there were an occasional year when he was not resident here.[41]

In *Grace v HMRC*[42] the Special Commissioners reached a compromise view. It is possible to be ordinarily resident and non-resident, but it does not happen much if at all in practice:

> If an individual is not resident in the UK, then it is difficult to find that he is ordinarily resident here.[43]

HMRC 6 takes the same line at para 1.5.15:

> In exceptional circumstances you may be not resident but still ordinarily

40 13 TC 485 at p.507.

41 [2007] STC (SCD) 23 at [190].

42 [2009] STC 213 Special Commissioners at [48].

43 This will need to be reviewed when the decision is final, but the High Court appeal did not consider this point.

resident in the UK. This is very rare ...[44]

HMRC 6 goes on to give an example of what those rare circumstances might be:

> You can be ordinarily resident in the UK but not resident. For example, if you normally live in the UK but, during a tax year, you have gone abroad for a long holiday and you do not set foot in the UK in the tax year. This is very rare.

There are two points in this statement, that a person who has gone abroad for a long holiday and is not present in the UK is (1) non-resident and (2) ordinarily resident.

HMRC 6 makes the same point at 3.2:

> It is also possible to be not resident in the UK but remain ordinarily resident here. If you normally live in the UK you might become not resident because you are not in the country at all during a tax year. As you would usually be resident in the UK and this is where you have your normal home, family ties and other social connections, you will still be ordinarily resident here.

It (which I doubt) this situation did arise in practice, it would play havoc with the DTT system. The INT Manual points out the difficulty and (perhaps) coyly suggests that the matter is dealt with by quiet concession:

> **69050. Not resident but ordinarily resident** [December 2006]
> A person who is not resident in the UK is chargeable to Capital Gains Tax on chargeable gains accruing to him in a year of assessment if he is ordinarily resident in the UK (Section 2 TCGA 1992). Strictly, no foreign

44 The sentence concludes: "... but if it did apply to you, you would also pay UK tax on your capital gains." This is correct though incomplete as it ignores other aspects of ordinarily residence. But one cannot expect HMRC 6 to be comprehensive.
HMRC 6 makes the same point at 3.1: "However, even if you are not resident in the UK, you may be ordinarily resident and if so, you may be liable to UK tax on the disposal of UK and/or foreign assets".
HMRC leaflet NRN2, question 8 provides:
"Were you resident in the UK in the year to 5 April 2004?
If 'NO', you are not ordinarily resident in the UK."
But it is inevitable that a short guide such as NRN must over-simplify.

> tax credit relief is due (either under a treaty or unilaterally), because the person concerned is not resident in the UK. If a claim to tax credit relief is made in these circumstances, the case should be submitted to the Offshore Personal Tax Team (part of Charity, Assets & Residence).

3.11 HMRC practice before 2008/09: IR20

3.11.1 *Practice prior to 1936*

The topic of residence was considered by the Income Tax Codification Committee (1936), a committee including all the leading UK tax figures of the day. The Committee criticised the statute law. It was "remarkable" that the Income Tax Acts afforded no greater assistance in the solution of the problem than the rules (now in ss 829–832 ITA 2007) which are "of limited application". Nothing has changed there. There is one clear rule (the 183-day rule) and a few confusingly worded generalities, which substantially date back to the distant origins of Income Tax.

The Committee also criticised the case law: "Nor are the decisions of the Courts very helpful." Nothing has changed there either. The two House of Lords cases which governed the position back then (*Lysaght*, *Levine*) continue to do so now. Residence is now, as it was then, "a question of fact, on which the decision of the Commissioners before whom the matter comes on appeal is final unless the Courts decide that there was no evidence on which the Commissioners could properly have come to the conclusion at which they arrived".

The Committee concluded that:

> the present state of affairs, under which an enquirer can only be told that the question whether he is resident or not is a question of fact for the Commissioners but that by the study of the effect of a large body of case law he *may* [emphasis added] be able to make an intelligent forecast of their decision, is intolerable and should not be allowed to continue.[45]

3.11.2 *Practice from 1936 to 2007*

The situation did not continue, though the change was not the one that the Committee had asked for. The Committee reported that in the 1930s "no

45 Income Tax Codification Committee Report Cmd.5131 pp.34–39.

one subject which arises in the application of the Income Tax Acts has been more prolific of dispute than the question of the meaning of residence in the UK". This was "in no way surprising" given the state of the law. Now, immediately after (no doubt as a result of) the Codification Committee report, the position in this respect changed completely. For sixty years – from 1936 until *Shepherd v IRC* in 2006 – there were virtually no reported cases on residence, the only important exception being *Reed v Clark*. The topic of residence ceased to be "prolific of dispute". The reason was that the Revenue published guidance provided most of the bright line guidance which was needed, although the general tax law did not. From 1937 – 2009 the guidance was in IR20, though the basis of that guidance was already formulated in 1936 and is set out in the Codification Committee report.

In the 2007/08 edition of this work I noted some objections to the practice set out in IR20:

> The first set of objections is constitutional ... The rules in IR20 – if they are worth the paper they are written on – are best regarded as tertiary legislation.[46] Although IR20 purports to state the law on residence, it has only a tenuous connection with the law declared by Parliament and applied in the Courts. IR20 was issued without statutory authority. One consequence of this is that IR20 has been issued without the parliamentary scrutiny which tax legislation should receive. Nor have the rules ever been subject to public consultation. Another consequence is that appeals to the Courts are made very difficult. ... All in all, the current state of affairs (one cannot properly call it the current state of the law) is fit only for a banana republic.

The 1955 Royal Commission noted this was "unsatisfactory" and recommended reform.[47] The ill-fated 1988 Consultation Document (Residence in the UK) made proposals. More recently, STEP called for reform[48] and so did the CIOT ("the law determining whether an individual is resident in the UK is a mess").[49] The House of Lords Economic Affairs

46 This is the view of the ICEAW: see Towards a Better Tax System, May 2000, accessible *www.icaew.com/publicassets/00/00/04/43/0000044306.PDF* p.38.

47 Royal Commission on Income Tax, Final Report, Cmd 9474 Chapter 14. The whole section on residence is worth reading and accessible on *www.kessler.co.uk*.

48 "Need for Statutory Residence Test" 23 November 2007 *www.step.org/showarticle.pl?id=1971*

49 "Residence for tax purposes" 14 November 2007 accessible *www.kessler.co.uk*.

Committee agreed.[50] But no statutory changes have yet been forthcoming.

3.11.3 *The end of IR20 from 2008/09*

IR20 was summarily revoked on 31 March 2009, with effect from 6 April 2009, thus giving six days' notice of the new rules in HMRC 6.

HMRC 6 makes it clear that the old IR20 is now dead and buried:

> This guidance replaces IR20. ... Any practices associated with the IR20 – whether overtly expressed or not – will not apply from 6 April 2009, unless provided for outside the IR20.

There is no transitional relief for those who might have been relying on IR20 in arranging their affairs for 2009/10. In this manner, a fundamental change to the scope of UK taxation was carried out without consultation or any public discussion of any kind.[51]

HMRC are also arguing that they are not bound by the terms of IR20 even for the years before its revocation in 2009/10. We will know the answer to that question when the *Gaines-Cooper* litigation is final.

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

> "223. We were unable to glean from officials why legislation was not included in this year's package. They did not present the case for inclusion or against. It is disappointing that officials were less than forthcoming on this important issue.
>
> 224. We recognise that it will not be possible to include a comprehensive statutory definition of UK residence in this year's Bill.
>
> 225. However, we think this is something which should be taken forward as rapidly as possible so that Ministers are able to come to a view in good time before next year's Bill. We therefore recommend that HMT and HMRC should consult with the professional bodies over the coming months, building on the work which was done in 2003."

51 I do not count the consultation issued on 15 September 2008. This gave no indication that major changes were to be made, and strongly implied exactly the opposite ("We recognise that the time has come for a complete rewrite to reflect changing circumstances such as increased international mobility since the IR20 was first written. We want our replacement guidance to reflect a style which meets our current guidelines, is engaging for our customers and meets the highest standards of customer service...we are not inviting comments on the legislation, HMRC policy or practice on residence and domicile issues ...").

None of this would have been possible had the law been on a proper statutory basis. One lesson to be learned is that constitutional fundamentals *do* matter.

3.12 HMRC 6

HMRC 6 was published on 31 March 2009. What was published was a draft and not a final version. Quite soon afterwards[52] HMRC quietly replaced it with a revised version, more neatly laid out and with many stylistic improvements but no changes of substance as far as I can see.

HMRC say:

> The guidance [HMRC 6] is aimed at unrepresented individuals.[53]

There are in fact two aspects of HMRC 6 (as there were for IR20). The first is a (relatively) brief guide to taxation generally. This is for unrepresented individuals, and professionals will not find it of interest. The second is a guide to residence and ordinary residence. This is vital to professionals (as was IR20) for it is the closest there is to an HMRC guide to the meaning of these terms.

3.12.1 *HMRC 6: who determines the issue of residence*

HMRC 6 para 2 provides:

> It is important that you understand what *we* mean by "resident in the UK" for tax purposes because this will determine what UK tax you have to pay.

Strictly the question is what *Parliament* means by "residence" and not what HMRC mean. The (unnamed) authors of HMRC 6 may think the distinction pedantic. But HMRC says more than once that the way to find out if one is resident is to ask them:

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52 There was no public announcement but it seems that this was done by 17 April 2009. I infer that the draft had to be published as it needed to be in place before 6 April 2009.

53 Replacement Guidance on Residence and Domicile – Feedback published 31 March 2009 accessible *www.hmrc.gov.uk/cnr/feedback.pdf.*

> 8.1 ... Your tax office can also help you work out if you will become non-resident and/or not ordinarily resident.
> 8.4 ... In all of these circumstances, you should write to the HMRC office dealing with your type of employment abroad. ... We will be happy to give you advice on your particular circumstances. ...

The rule of law requires a system where taxpayers or their advisors can work out for themselves whether they are resident. Is this so obvious that it goes without saying? We cannot be sure.

3.12.2 *HMRC 6: disclaimers*

One of the issues in the *Gaines-Cooper* judicial review case is whether the disclaimers at the front of IR20 have the effect that HMRC are free to disregard its content. Whatever the result of that litigation, HMRC wished to put themselves completely free to argue against HMRC 6 in case a taxpayer wished to rely on it:

HMRC 6 section 1 provides:

> [1] However, this document only offers general guidance on HMRC's view of how the rules apply and does not have legal effect. [2] Whether this guidance is appropriate in a particular case will depend on all of the facts of that case.
> You are responsible for your own tax affairs in the UK but we might ask you about your tax affairs at some time. [3] This guidance will tell you the main factors that we at HMRC take into account when deciding your residence, ordinary residence and domicile status for UK tax purposes. [4] It is general guidance which is designed to help you reach a decision yourself. [5] We accept that these are not straightforward subjects and our guidance might not cover all of the issues which affect you. [6] You might find that your personal circumstances are more complex than the simple guidance we provide here and that you need to contact us to obtain further information or seek the services of a professional tax adviser.
> 1.2... This guidance tells you the main factors we take into account when deciding your residence and ordinary residence status. Your status is determined by the facts of your particular case...

Six variant wordings of disclaimer in the first paragraph, two of which are repeated later on. I infer that the wording was drafted by a lawyer with one eye firmly on a possible successor litigation to *Gaines-Cooper* even though HMRC 6 contains far less clear guidance than IR20.

3.12.3 *HMRC 6: types of residence*

HMRC 6 divides residence into various categories. Leaving aside the 183 day rule, the primary distinction is between:

(1) those leaving the UK ("leavers"); and
(2) those coming to the UK ("arrivers").

These are subdivided as follows:

(1) *Leaving the UK* is divided into three understandable categories:
    (a) full-time workers abroad;
    (b) permanent or indefinite leavers;
    (c) the "year out" category.
(2) *Coming to the UK* is divided in a more confusing way:
    (a) the three years in the UK practice;
    (b) remaining two years in the UK practice;
    (c) visitors to the UK

3.13 The 183-day rule

HMRC 6 adopts the 183 day rule:

> 1.5.22... If you are in the UK for 183-days or more in the tax year, you will always be resident here. There are no exceptions to this. You count the total number of days you spend in the UK – it does not matter if you come and go several times during the year or if you are here for one stay of 183-days or more.
> 2.2 ... The only occasion when the number of days that you are physically present in the UK will determine your residence status here is when you are physically present in the UK for 183-days or more during a tax year. In all cases when you are physically present in the UK for 183-days or more, you will be resident here in that tax year. **There are no exceptions to this.**

This has a sound basis in the statutory 183-day rule.[54]

3.14 Short absences

HMRC 6 para 8.1 provides:

> If you normally live in the UK and go abroad for short periods – for example on holidays and business trips – you will continue to be resident here. This type of short absence from the country does not affect your UK residence and ordinary residence position.

This is obviously correct. It has a sound basis either in the ordinary meaning of "residence"[55] or perhaps in the occasional residence abroad rule.

3.15 Full-time work abroad

HMRC 6 para 8.5 provides:

> **8.5 Leaving the UK to work abroad as an employee**
> If you are leaving the UK to work abroad full-time, you will only become not resident and not ordinarily resident from the day after the day of your departure, as long as:
> • you are leaving to work abroad under a contract of employment for at least a whole tax year
> • you have actually physically left the UK to begin your employment abroad and not, for example, to have a holiday until you begin your employment
> • you will be absent from the UK for at least a whole tax year
> • your visits to the UK after you have left to begin your overseas employment will
> - total less than 183 days in any tax year, and
> - average less than 91 days a tax year....
> **If you do not meet all of these conditions, you will remain resident and ordinarily resident in the UK unless paragraph 8.2 applies to you.**
> **If your employment comes to an end and you do not return to the UK it will be necessary to consider if you continue to be not resident and**

54 See 3.3 (Temporary UK purpose and 183 day rules).
55 See the passage from *Levene* set out at 3.8 (Case law on residence).

not ordinarily resident in the UK.

I refer to this as "**the full-time work abroad practice**". The main points of this practice have survived from the old IR20 though some details have changed.

One change concerns holidays. According to HMRC 6, if the employee goes on holiday before work starts, he is still UK resident until work starts. I find that bizarre.

3.15.1 *Meaning of "work full-time abroad"*

There are two requirements here: the work must be:

(1) "full-time" and
(2) "abroad".

The term "full-time" is explained in HMRC 6 para 8.5:

> What we mean by "full-time employment":
> UK tax law does not give a definition of "full time employment". The decision on whether or not you are employed abroad full-time will depend on the particular circumstances of your case. If you say that you are working abroad full time, we would expect you to be able to show that your employment:
> • has a standard pattern of hours which can be compared to a typical UK working week or
> • if your employment does not have a formal structure or fixed number of working days, it can, by looking at the
> local conditions and practices of the particular occupation, be compared to similar full-time employment in the country where you are working.

The old IR20 added:

> If you have several part-time jobs overseas at the same time, we may be able to treat this as full-time employment. That might be so if, for example, you have several appointments with the same employer or group of companies, and *perhaps* also where you have simultaneous employment and self-employment overseas. But if you have a main employment abroad and some unconnected occupation in the UK at the same time, we will consider whether the extent of the UK activities was

consistent with the overseas employment being full-time.[56]

I wonder if the omission is deliberate. There is no indication either way.

There is no guidance as to the requirement that the work is "abroad". It is suggested that the work must be substantially done abroad and any UK work (other than incidental duties) would have the result that the condition of full-time work abroad is not satisfied. This would be consistent with other areas of tax law: see 12.5 (Where are duties performed: incidental duties).

3.15.2 *Employees not within the full-time work abroad practice*

HMRC 6 para 8.4 provides:

> **8.4 Leaving the UK to work abroad – employees not covered by this guidance**
> There are special rules for some employees who work abroad which are not dealt with in this guidance. This guidance will not apply to you if you are:
> • a Crown employee (for example, a member of the UK armed forces, a civil servant, diplomat)
> • an employee of the institutions of the European Union (EU)
> • a UK Merchant Navy seafarer
> • an Oil and Gas exploration/extraction industry employee (when your employer is not resident in the UK).

3.15.3 *Returning to the UK after working abroad*

HMRC 6 para 8.6 provides:

> **8.6 Returning to the UK after working abroad**
> If you were not resident and not ordinarily resident when you were working abroad and you return to the UK when your employment ends, you will be not resident and not ordinarily resident in the UK until the day before you return to the UK. You will become resident and ordinarily resident on the day you return to the UK unless you can show that your return was simply a short visit to the UK between two periods of full-time employment abroad. ...

56 (Emphasis added) RI 40 comments further on the meaning of "full-time".

3.15.4 *Changes to employment while abroad*

HMRC 6 para 8.7 provides:

> **8.7 Changes to your employment when abroad**
> If your circumstances change while you are abroad, for example there is a break in full-time employment, you might no longer meet the requirements of paragraph 8.3 and so remain resident and ordinarily resident in the UK. You must tell us about such changes by contacting your tax office.
> You must also tell us when you return to the UK at the end of an overseas employment, even if you are planning to go abroad again to work under a new contract of employment. You must do this even though you see your return to the UK as temporary and for a very short period and you should tell us this information by contacting your tax office.

Notwithstanding the peremptory terms of this paragraph, there is no obligation to disclose anything to HMRC unless the individual becomes UK resident.

3.15.5 *Self-employment*

HMRC 6 para 8.8 provides:

> **8.8 Leaving the UK to become self-employed abroad**
> If you are leaving the UK to work abroad for yourself in a trade, profession or vocation, then as long as your working circumstances are similar to those outlined in paragraph 8.5, you will be taxed in the same way.

3.15.6 *Partly employed and partly self-employed*

A published HMRC letter of 10 July 1979 provided:

> ... where an employee left the UK on 4 April 1979 and did not return until 6 April 1980 and was on a full-time service contract during that period, he would be regarded as not resident and not ordinarily resident in the UK throughout the year 1979–80.
> However this practice would not be extended to a taxpayer who was only partly in employment and partly self-employed during a similar period.

> In such circumstances the normal rules for determining an individual's residence status would apply and on the basis that no visits were made during the intervening period, the taxpayer would be regarded as not resident but ordinarily resident for the year 1979–80 in these circumstances.

I find this bizarre, and consider that a court is not likely to draw a distinction between those working full-time in either employment or self-employment, and those partly employed and partly self-employed. The former IR20 para 2.5 (set out above) watered this down to a "perhaps". Now there is no guidance at all.

3.15.7 *Accompanying spouse concession: ESC A78*

ESC A78 provides:

> **A78 Residence in the UK: accompanying spouse**
>
> 1 The residence and ordinary residence status of a husband and wife is determined independently but the circumstances of one spouse may, in certain situations, be taken into account when determining the residence status of the other. This can apply when one spouse goes abroad for full-time employment, or to work full-time in a trade, profession or vocation, and is regarded as not resident and not ordinarily resident from the day following departure to the day before return. The following concession applies where an individual in this position is accompanied, or later joined, by his or her spouse who is not in full-time employment (or working full-time in a trade, profession or vocation) abroad.
>
> 2 Where the accompanying spouse is abroad for a complete tax year and interim visits to this country do not amount to—
>
> – 183 days or more in any tax year; or
> – an average of 91 days or more in a tax year (the average is taken over the period of absence up to a maximum of four years);
>
> then the accompanying spouse's liability to UK tax which is affected by residence, for the years of departure and return at the beginning and end of the period spent abroad, will be determined by reference to the period of his or her residence here during the year.

The concession (like all concessions) applies to civil partners.[57] HMRC 6 para 8.9 provides:

> **8.9 Leaving the UK with your spouse or partner**
> When your husband, wife or civil partner leaves the UK to work abroad within the terms of paragraphs 8.5 or 8.8, you are able to receive the same tax treatment if you accompany or later join them abroad. This treatment is by concession (extra-statutory concession A78) and means that even when you yourself are not in full-time employment abroad, you will also be not resident and not ordinarily resident in the UK from the day after your
> departure. This treatment will apply as long as:
> • you will be absent from the UK for at least a whole tax year, and
> • your visits to the UK after you have left
> – total less than 183 days in any tax year, and
> – average less than 91 days a tax year. This average is taken over the period of absence up to a maximum of four years – see 8.3 which will show you how to work out this average. Any days you spend in the UK because of exceptional circumstances beyond your control, for example an illness which prevents you from travelling, are not normally counted for this purpose).
> You will remain not resident and not ordinarily resident in the UK until the day **before** you return to the UK. You become resident and ordinarily resident on the day you return to the UK.

3.16 Seafarers and nomads

Rogers v Inland Revenue 1 TC 225 concerned a master mariner. Captain Rogers had a house in Fife where his wife and children resided. He had no home in any other country, but in the year 1878/79 he was entirely absent from the UK while in command of his ship. In fact he was away for much more than one year as he left in July 1877. Captain Rogers was held to be resident here:

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57 HMRC stated in their online list of ESCs:

> "The Government's commitment is that, for all tax purposes, same-sex couples who form a civil partnership will be treated the same as married couples.
> As part of this commitment to tax parity, from 5 December 2005 all Extra Statutory Concessions (ESCs) or Statements of Practice (SoPs) should be taken as extended to apply equally to civil partners and married couples."

> Every sailor has a residence on land, … and the question is, Where is this man's residence? The answer undoubtedly is that his residence is in Great Britain. He has no other residence, and a man must have a residence somewhere.

(The ship was not regarded as a residence.)

The view that one can spend all year outside the UK and still be UK resident is supported by s.829(2) ITA.[58]

However, HMRC practice is now quite different and the full-time work abroad practice is applied to sailors. EI Manual 70230 provides:

> **Tax treatment of seafarers: Residence status: Employment outside UK territorial waters**
>
> A seafarer will normally be regarded as not resident and not ordinarily resident in the UK from the day following departure to the day preceding return where he or she:
>
> - has been ordinarily resident in the UK and leaves the UK to take up full-time employment on a ship and
> - the absence from the UK and the period of service includes a complete tax year and
> - leave spent in the UK totals less than 183 days in any tax year and averages less than 91 days for each tax year (the average is taken over a period of absence up to a maximum of 4 years).
>
> However, this will not include seafarers whose employment arrangements consist of frequent and regular voyages to and from the UK.

The *Rogers* principle will apply to those who:

(1) do not work full-time and
(2) leave the UK to wander the world for a year without coming back to the UK.

Backpacking gap-yearers may fall into this category, or those on a leisurely world cruise. But in practice this is not likely to arise very often.

58 "Treat the individual as UK resident for the purpose of determining the individual's liability for income tax for any tax year during the *whole or* a part of which the individual remains outside the UK for the purpose only of occasional residence abroad." (Emphasis added)

3.17 "Year out" non-residence

Dave Clark left the UK on 3 April 1978 and returned on 2 May 1979. I shall call that time "the year out". He was UK resident before and after the year out, and UK domiciled at all times.

During the year out he spent virtually the whole time in or around Los Angeles. The taxpayer worked in Los Angeles. Presumably he did not work full-time so he did not fall within the scope of the full-time work abroad practice. For the first ten weeks of his stay he lived in a house lent by a friend and thereafter in a house rented by his company. He retained a leasehold flat in Mayfair (also held by a company). He wisely spent no time in the UK at all.

It was held that the only possible conclusion from these facts was that he was not UK resident in the year out.[59]

HMRC relied on *Rogers v Inland Revenue*.[60] The taxpayer argued that these cases were confined to wanderers with no place of residence except a base in the UK from which they started and to which they returned. It was different if a taxpayer establishes a home in another country. The court did not expressly accept this formulation, and declined "to define in the abstract circumstances in which it would or would not be open to Commissioners as the fact finding tribunal to conclude that a person physically absent for a whole year nonetheless resides here. Circumstances of particular cases vary widely, and each case must depend on its own facts". But the taxpayer's formulation seems soundly based. It was therefore relevant to the decision that Dave Clark was not merely out of the UK for the year: he lived in a new home, mostly in one fixed place of abode, and he worked from there. Los Angeles was his "headquarters".

The second string to HMRC's bow was the occasional residence abroad rule. It was argued that Dave Clark had left the UK for the purpose of "occasional residence". On this point the Judge held that "occasional" residence was the opposite of "ordinary residence". He said that Mr Clark was indeed "ordinarily resident" in America. Accordingly he had not left the UK for "occasional residence" abroad.

It follows that a person who:

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59 *Reed v Clark* 58 TC 528.

60 See 3.16 (Seafarers and nomads). A court may be less sympathetic to HMRC in a similar case now that HMRC are known to ignore *Rogers* in practice.

(1) wishes to leave the UK for a period of one tax year;
(2) does not work full-time abroad, so does not come within the scope of the full-time work abroad practice

may acquire non-residence by a "year out". I refer to this as "**year out**" non-residence, though "non-full-time worker's year out" would be more accurate. The individual should ideally spend no time whatsoever in the UK in the relevant tax year.[61] He must acquire a "base" in his new place of residence. Although Dave Clark worked (part-time), it is considered that the position would be the same had he not worked. Although Dave Clark had a single place of residence, it is considered that the position would be the same if he had more than one, as long as they were "base" or "headquarters".

3.17.1 *HMRC practice*

HMRC 6 hardly mentions this category of non-residence but there is a passing reference at 1.5.15:

> You can be ordinarily resident in the UK but not resident. For example, if you normally live in the UK but, during a tax year, you have gone abroad for a long holiday and you do not set foot in the UK in the tax year. This is very rare.

As far as residence is concerned, this is a more generous statement than the rule in *Reed v Clark*, which only results in non-residence if the individual has a base in his new place of residence. As far as ordinary residence is concerned, it is (I think) rather stricter than the law.

HMRC form SA 109 Notes (12/07) provides at question 1:

> Were you present in the UK at any time during the year ended 5 April 2008?
> If "No", you are not resident in the UK.

But it is inevitable that a short guide must over-simplify.

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61 In practice a few days in the UK should not make any difference. But it is impossible to say where the dividing line comes.

3.18 Leaving the UK permanently or indefinitely

For many decades HMRC operated a 91-day test. In short – I omit refinements which do not affect the position in general – what you formerly had to do to lose UK resident status under IR20 was to average under 91 days in the UK over the three-year period. HMRC withdrew from this practice in Business Brief 1/2007, which was later set out as an appendix in the May 2008 version of IR20. HMRC seek to apply this practice retrospectively. Whether they were entitled to do this retrospectively is the issue in the *Gaines-Cooper* judicial review application. But whatever the position as to the past, from 2009/10 the 91-day test is no longer decisive. HMRC use bold font and repetition to emphasise how strongly they feel on the issue:

> 1.2 .. Your status is determined by the facts of your particular case. It is **not** simply a question of the number of days you spend in the country.
> 1.5.13...Being resident in the UK is not simply a question of the number of days you spend in the country....
> 1.5.22 The number of days you are present in the country is only one of the factors to take into account when deciding your residence position....
> 2.2 ... There are many different factors which will determine whether you are resident in the UK during a tax year. **With one exception [the 183-day test], it is not simply a question of the number of days you are physically present in the UK during a tax year although this is an important consideration.**

So we need to consider when a UK resident person loses UK resident status other than under the full time work abroad rule or the year out rule. HMRC 6 para 8.1 provides some terminology:

> **By leaving the UK "permanently" we mean that you are leaving the country to live abroad and will not return here to live. By leaving "indefinitely" we mean that you are leaving to live abroad for a long time (at least three years) but you acknowledge that you might eventually return to live here.**

(Bold font is original.) This is a commonsense definition of "permanently". It is a slightly odd use of "indefinitely" ("long-term" would be nearer the mark) but not too confusing. HMRC 6 then provides a summary of the position:

> If you have been resident and ordinarily resident in the UK, the act of leaving the UK to go abroad does **not** mean that you will automatically become non-resident and/or not ordinarily resident. After you leave the country, your UK residence and ordinary residence position will be affected by a number of factors which include:
> [1] the reason you have left the UK (for example to work or live abroad permanently)
> [2] what visits you make to the UK after you have left
> [3] what connections you keep in the UK such as family, property, business and social connections.

Para 1.5.22 has similar generalities which apply to leavers and arrivers:

> If you are here for less than 183 days, you might still be resident for the year.
> You should always look at the pattern of your lifestyle when deciding whether you are resident in the UK. Things you should consider would include what connections you have to the UK such as family, property, business and social connections. Just because you leave the UK to live or work abroad does not necessarily prove that you are no longer resident here if, for example, you keep connections in the UK such as property, economic interests, available accommodation, and social activities or if you have children in education here.
> For example, if you are someone who comes to the UK on a regular basis and have a settled lifestyle pattern connecting you to this country, you are likely to be resident here.

Para 8.2 has a little more to say:

> **8.2 Leaving the UK permanently or indefinitely**
> If you are leaving the UK permanently or indefinitely, you will only become not resident and not ordinarily resident from the day after the day of your departure, as long as you have actually physically left the UK and have left for the purpose you have stated, not for example, to have a holiday until you move into your new home or begin your overseas employment.
> You can still visit the UK but if your visits here after you have left average 91 days or more in a tax year, you will remain resident and ordinarily resident in the UK.
> If you say that you are no longer resident and ordinarily resident in the UK, we might ask you to give some evidence to show that you have left the UK permanently or indefinitely. For example, we would expect you

> to show that when you left the UK you had acquired accommodation abroad to live in as a permanent home.
> **The act of leaving the country is not likely to be sufficient evidence that you have left the UK permanently and have become non-resident and not ordinarily resident.**
> If you still have property in the UK which you can use after you leave, we might want you to explain why you are retaining that property when you say you have left the UK.

In the HMRC view, a person who averages 91 days in the UK does not cease to be resident. This is not reconcilable with their statement that it is not just a matter of counting days, but it is a rule of thumb which has survived from IR20. What is the position for someone who spends less than 91 days here? One could call HMRC 6 passage a correct summary of the case law, but one should not call it "guidance". For the reader uncertain of his or his clients position is unlikely to find in it anything that helps him. What is to be done for the client who asks the wholly reasonable question: what can I do in the UK without becoming UK resident?

3.19 Calculating annual average visits

3.19.1 *Illness and exceptional circumstances*

HMRC 6 provides:

> 2.2 ... When considering days of presence in the UK under the rules from 6 April 2008, and under the rules for previous years, days you have spent in the UK because of exceptional circumstances beyond your control may be disregarded. This will not apply if the days you have spent in the UK in a tax year, including those spent here because of exceptional circumstances, are equal to or exceed 183 days.
> 8.5 ... Any days you spend in the UK because of exceptional circumstances beyond your control, for example an illness which prevents you from travelling, are not normally counted for this purpose.

SP 2/91 makes similar but not identical points:

> **SP 2/91 Residence in the UK—visits extended because of exceptional circumstances**
> 1 Under TA 1988 s 336, an individual is not regarded as resident in the UK in a year of assessment if, broadly,

(a) he is in this country for some temporary purpose only and without the intention of establishing his residence here, and
(b) he has not, in the aggregate, spent at least six months in the UK in that year.

2 In applying the first condition, one of the considerations is that an individual is regarded as resident in the UK if visits to the UK average at least three months in a tax year; the average is calculated over a maximum of four years. Where this rule applies, any days which are spent in the UK because of exceptional circumstances beyond an individual's control, for example, illness, will be excluded from the calculation.

3 Each case where this relaxation of the normal rules may be appropriate will be considered in the light of its own facts. The statutory condition in para 1(a) above must of course continue to be met, and the relaxation does not apply for the purposes of calculating the six months in para 1(b) above.

This recognises that a person may spend up to 182 days present in the UK if necessary for medical care and still be non-resident. The practice is merciful to the non-resident and helpful to the private medical industry, except for long term patients.

SP 2/91 omits the word "normally", but para 3 ("each case considered in the light of its own facts") has a similar effect. The only situation I can envisage where the practice would not apply is in cases of abuse, e.g. if a UK resident individual "left" the UK knowing he would need to return shortly for medical treatment.

Of course the practice would not apply if the illness was mild and did not actually cause the individual to stay here. The decision to stay must be "beyond your control", a matter of compulsion rather than choice.

Time spent in the UK because of the taxpayer's own illness is fairly straightforward. The practice recognises that a person may need to spend time in the UK because of the illness of immediate family. Remaining in the UK because of the illness of one's family is strictly a matter of choice but "beyond your control" must be taken sensibly rather than literally.

"Immediate family" is not defined. It is suggested that the term must include parents as well as children. For a child is clearly "immediate family" and it would be odd if S was the immediate family of P, but P was not the immediate family of S.

This practice is not applied for the 183-day rule. There is perhaps a reason for this: the 183-day rule is statutory, so to disregard days of illness or exceptional circumstances would have to be classified as a concession, not simply as an HMRC practice. But the 183-day rule can therefore operate rather harshly.

3.20 Days of arrival and departure

Section 831 ITA provides:

> (1A) In determining whether an individual is within subsection (1)(b) treat a day as a day spent by the individual in the UK if (and only if) the individual is present in the UK at the end of the day.
> (1B) But in determining that issue do not treat as a day spent by the individual in the UK any day on which the individual arrives in the UK as a passenger if–
> (a) the individual departs from the UK on the next day, and
> (b) during the time between arrival and departure the individual does not engage in activities that are to a substantial extent unrelated to the individual's passage through the UK.

Section 832(1A)(1B) ITA provides the same rule for employment income, and s. 9(5)(6) TCGA provide the same rule for CGT.
EN FB 2008 provides:

> 15. Although case law precedent from the 1950s (*Wilkie v CIR,* 32 TC 495) established the principle that in computing the length of time spent in the UK it was correct to take hours into account, that approach was thought to be too much of an administrative burden both for the individuals concerned and for the Department in terms of investigating compliance. HMRC therefore continued its normal practice of ignoring days of arrival and departure except where the facts in an individual case predicated a different approach.

The last 12 words are designed to leave HMRC freedom to take the points discussed above.

> Such treatment meant that the UK is now out of step with many of its international partners in determining the issue of an individual's residence for tax purposes.

There were essentially two changes in 2008: a change to the 183-day rule and a change to the 91-day rule. In applying the change to the 183-day rule the EN is correct, the change is in line with international practice. In applying the change to the 91-day test, the EN is wrong. The 91-day test is out of line with international practice and by making the test more stringent the UK has become more out of line with international practice than before. But there it is.

> 16. Recent case law has indicated that HMRC's guidance on "day-counting" as it stands creates a degree of uncertainty.

In fact the only uncertainty (which the *Gaines-Cooper* litigation will resolve) was whether the IR20 guidance was binding on HMRC. Inaccuraces of this kind are becoming common, but they should not go unnoticed.

> The Government considers that legislation is required and that the treatment of days of arrival and departure should reflect the growing ease of international travel and an increasingly global workforce.
> 17. The changes to the legislation introduced in the clause are in respect of the 183-day test only. However, where current HMRC practice requires the use of day-counting to determine residence for tax purposes, that practice will also be changed in line with the statutory amendment introduced in this clause. From 6 April 2008 all day counting tests, such as the non-statutory 91-day test, will follow the same principle that any day where the individual is in the UK at the end of the day will be included as a day of residence. The same exception from that general rule will apply where the individual is a passenger in transit and their activities whilst in the UK are not substantially unrelated to that travel.

It says a great deal about how far law and practice had drifted apart that this major extension of the scope of UK taxation was thought not to need any statutory authority. But since the 91-day test did not exist in law, it would be impossible to make the change by statute without creating a statutory 91-day test, effectively putting the law of residence on an entirely new basis.

When is a person "present in the UK"? I would have said a person is "present" once a boat reaches UK territorial sea[62] or once a plane flies over the territorial sea. But HMRC take a different view:

> The published answer [from HMRC] confirmed that "the point of arrival

62 See Appendix, 1.1.4 (Territorial sea).

> in the UK will be when, an aircraft lands, a train arrives at the first station in the UK, a boat docks at the quayside or drops anchor in territorial waters". HMRC were asked to confirm that similar rules applied to determine the time of departure. HMRC confirmed that the departure rules were consistent with those described for arrival ie "the point of departure from the UK will be when, an aircraft takes off, a train leaves the last station in the UK, a boat leaves the quayside or its anchorage point in territorial waters".[63]

That time is certainly earlier to ascertain.

3.20.1 *Transit passenger*

Under s.831(1B)(b) ITA a day of arrival can only be disregarded even though the individual is present at midnight, if

> during the time between arrival and departure the individual does not engage in activities that are to a substantial extent unrelated to the individual's passage through the UK.

This is vague, but it will not often need to be considered. HMRC 6 provides a gloss:

> So, for example, if you attend a business meeting, visit a property you own, arrange to meet people socially or attend social activities, you must count that day as a day of presence if you are in the UK at the end of the day.

EN FB 2008 provides some unexceptionable examples:

> *Example 1* – Peter works for the Jersey arm of HSBC and is travelling from Jersey to Frankfurt. He flies from Jersey to Gatwick and will catch his onward flight the next day to Frankfurt from London City airport. He travels from Gatwick to Canary Wharf for a meeting with several other HSBC colleagues before staying overnight in a nearby hotel.
> The meeting with colleagues is not an activity substantially related to completing travel to a foreign destination. The transit passenger

63 Joint Forum on Expatriates Tax and NICs Note of Meeting 18 September 2008 accessible *www.hmrc.gov.uk/consultations/expat-mins-180908.htm*

provisions will not apply.

Example 2 – John works for the Jersey arm of HSBC and is travelling from Jersey to Frankfurt via Gatwick and London City airport. In lobby of his hotel near London City Airport, he unexpectedly spots another colleague who has just arrived from Paris. They have a couple of pints together and their conversation covers a number of business-related issues. Peter then travels to London City airport to catch his onward connection. This meeting was not planned and therefore it can be considered that John's activities in the UK substantially related to completing travel to a foreign destination. The transit passenger provisions will apply.

Example 3 – Shirley lives in Guernsey and is travelling to New Zealand by way of Gatwick and Heathrow. She has planned to spend most of the day with her daughter and grandchildren, who live in Crawley and will also spend the night there before travelling to Heathrow for her onward flight.

Her visit is not an activity substantially related to completing travel to a foreign destination. The transit passenger provisions will not apply.

Example 4 – Phil lives in Guernsey and is travelling to New Zealand by way of Gatwick and Heathrow. His flight from Guernsey is delayed by fog and he arrives too late to make his onward connection to New Zealand that day. His son had already arranged to meet him at Gatwick and drive him to Heathrow, now he drives him to a hotel near Heathrow instead where Phil will stay overnight before catching his rearranged flight. At the hotel they have a snack together.

These activities are substantially related to completing travel to a foreign destination – Phil would have eaten in the hotel even if he had been unaccompanied. The transit passenger provisions will apply.

Example 5 – George lives in the Isle of Man and is flying to New York on business via Manchester. He has made an appointment with a consultant orthopaedic surgeon based in Manchester to carry out a number of tests. He will stay in the clinic overnight before travelling on to New York the following afternoon.

The appointment is not an activity substantially related to completing travel to a foreign destination. The transit passenger provisions will not apply.

Example 6 – George lives in Jersey and is travelling to Stavanger. He does not fly and travels to the UK by ferry before continuing to London by train. He stays overnight at a West End hotel, having prearranged dinner and a trip to the theatre with friends. The next day he travels to Newcastle by train, where he boards a ferry to Stavanger. His activities in the UK are not substantially related to completing travel to a foreign destination. The transit passenger provisions will not apply.

If the individual arrives in the UK and leaves on the *same* day, that day will not count even though work or other matters are done in between. The individual does not need to rely on the transit passengers exemption.

3.20.2 *Transitional aspects*

The transitional issues were overlooked at the time of the FA 2008, but HMRC have dealt with this in the December 2008 Qs and As:

> **Day counting**
> **Q** For determining residence in 2008-2009, do I need to count one of the arrival-departure days for each visit during the previous three tax years (2007-2008, 2006-2007, 2005-2006) or does the old rule for counting (excluding departure - arrival) apply for those years?
> **A** For 2007-08 and before, the old day counting practice (excluding days of arrival and departure) will continue to apply. For 2008-09, the new practice (counting days where the individual is present at the end of the day) will be applied. So when calculating periods of residence that straddle both sets of practice, individuals will have to take into account both of the day counting practices. You should therefore exclude days of arrival and departure for 2005-06, 2006-07 and 2007-08.

This is a sensible approach.

3.21 Method of calculating average

HMRC 6 provides:

> **8.3 How to calculate your average visits to the UK**
> **You only need to calculate the average of your visits to the UK**
> **[1] after you have physically left and**
> **[2] have become non-resident and/or not ordinarily resident.**
> (Bold original).

Point [1] is self-evident. Point [2] is wrong because (as HMRC 6 states) the average is relevant (and sometimes decisive) in order to determine whether a person is UK resident.

> If you need to calculate your annual average visits to the UK, you do so like this:

> Total days visiting the UK x 365 = annual average visits
> Total days since leaving
>
> When you are making this calculation, you do not include the days which you spent in the UK in the year **before** your original departure. The calculation looks at a maximum of your visits in the most recent four years since you left the UK.

After a disclaimer which seems verging on paranoid[64] the text continues with a straightforward example:

> You left the UK to live abroad on 5 October 2007 and therefore became non-resident in the UK on 6 October 2007. A first review of your average visits is made after 5 April 2009. Since you left the UK on 6 October 2007 (that is, the day after the day of your original departure) your visits to the UK have been:
> 30 days between 6 October 2007 and 5 April 2008
> 50 days between 6 April 2008 and 5 April 2009
> The total number of days since you left the UK are:
> 183 days between 6 October 2007 and 5 April 2008 (the tax year ending 5 April 2008 fell in a leap year and so February 2008 has 29 days) and
> 365 days between 6 April 2008 and 5 April 2009
> To make the calculation, add up the total of your visits during the period of review – 80 days (30+50). You also add the total number of days that have passed since you left the UK during the period – 548 (183+365). You then divide the total number of your visits by the total number of days since you left the UK and multiply by 365 (the number of days in a year).
> The calculation would therefore be
> 80 x 365 = 53.28 days
> 548
> If you continue to remain abroad, the average of your annual visits is calculated in reviews after 5 April each subsequent year and following this example would be calculated like this:
> - Second Review after 5 April 2010 – include your visits from 5 October 2007 to 5 April 2010
> - Third Review after 5 April 2011 – include your visits from 5 October 2007 to 5 April 2011

64 **"This is an example for illustrative purposes and any calculation you make would be based upon your own circumstances – the date that you actually left the UK."** Bold font is original.

As the average is looked at over a maximum period of four years, after the third review, the year of departure is dropped from the calculation.

- Fourth Review, after 5 April 2012 – include your visits from 6 April 2008 to 5 April 2012.

This calculation, over the most recent four year period, would continue like this for as long as you remained out of the UK.

3.21.1 *The law*

According to HMRC 6 the number of days spent in the UK is determinative of UK residence in two cases:
(1) The 183-day test.
(2) The 91-day average test if the result is UK residence.
To ascertain the exact number is sometimes crucial.
In law, and in other cases within HMRC 6, by contrast, time spent in the UK (up to 183 days) is merely a factor to be taken into account.[65] So the question of exactly how one calculates days spent in the UK is less than crucial. In *Gaines-Cooper v HMRC* [2007] STC (SCD) 23 the Special Commissioners adopted figures which:

(1) counted days of arrival and departure as one day's presence (contrary to former IR20 principles) if the taxpayer stayed overnight;
(2) counted days spent in the UK due to illness (contrary to IR20 principles).

It is considered that the correct approach in law would be to take into account all days of arrival and departure, but with less weight than full days. But the *Gaines-Cooper* approach amounts to more or less the same.

3.22 Coming to the UK

The reader will recall that those coming to the UK are divided into the following categories:

(1) the three years in the UK practice;
(2) visitors to the UK, not within (1), a category divided into:
 (a) short-term visitors:

65 See 3.8 (Case law on residence).

(i) indecisive visitors;
(ii) intentional visitors;
(b) longer-term visitors.

3.23 The three years in the UK practice

HMRC 6 provides:

> **7.2 When you have come to the UK permanently or to live or work for three years or more**
> [1] ...If your home has been abroad and you have come to the UK to live here permanently you will be resident and ordinarily resident from the date you arrive.
> [2] You will also be resident and ordinarily resident from the date you arrive if you have come to the UK to **remain** here for three years or more. By saying that you have come here permanently or for at least three years, you have made it clear that you are not simply visiting the UK.

Limb [1] refers to those who "come to live here". Limb [2] refers to those who "come to remain here". Perhaps this means the same thing, so limb [2] covers just about everyone in limb [1].[66] Perhaps there is a slight difference in nuance, i.e. someone who comes to live in the UK permanently is resident even if they do not "remain" in the UK. In practice this is not likely to matter.

The heading "Coming to the UK permanently or indefinitely" is not an accurate label. I refer to this as "**the three years in the UK practice**".

3.23.1 *Meaning of "remain"*

HMRC 6 para 7.2 provides:

> When we say "remain" in the UK we meant that you are here on a continuing basis - the only trips you make outside the UK are when you go abroad for holidays or short business trips.

This is an odd use of the word "remain". "Stay full-time in the UK" would

66 Since anyone within [1] (who intends to come to the UK to live here permanently) will usually be within [2] (he intends to come and remain here for three years or more).

be a more accurate expression.

A person who "comes and remains" in the UK in the HMRC 6 sense will satisfy the 183-day rule and a person who "comes to live here" will do so too. So the only relevance of the three years in the UK practice is:

(1) to establish residence in the year of arrival (because the 183-day rule will not be satisfied by someone who arrives after about September);
(2) to establish residence in the year of departure (because the 183-day rule will not be satisfied by someone who leaves before September); and
(3) to establish ordinary residence.

3.24 Remaining in the UK for two years

HMRC 6 para 7.4 provides:

> If your home has been abroad and you have come to the UK but are not going to live here permanently or **remain** here for three years or more, you *may* be visiting the UK.

Emphasis added. The term "visitor" in the ordinary sense is vague. HMRC 6 uses the term "visitor" in a slightly defined and somewhat technical or artificial sense.

> You are **not** simply visiting the UK if, when you arrive:
> [1] you are going to be in the UK for 183 days or more during a tax year
> [2] you have come to the UK for a purpose which means that you will be remaining here for at least two years – for example, an employment.
> If either of these points apply, you will be resident in the UK from the day you arrive – see paragraph 7.2.
> Visitors to the UK are those people who are here for a temporary purpose and either of the above points indicates that your purpose for being here is **not** temporary.

Point [1] is the 183-day rule.[67] This section is considering point [2]. This category overlaps unhappily with the three years in the UK practice.[68] A person who intends to remain *three* years is in that category. A person who

67 See 3.13 (The 183-day rule).
68 See 3.23 (The three years in the UK practice).

only intends to remain *two* years is in this category.

A person who "remains" in the UK (in the HMRC 6 sense)[69] for two whole years will be present in the UK during three tax years.[70] During the middle tax year the person will satisfy the 183-day rule. The relevance of this practice is to establish residence in the tax years of arrival and departure if the 183-day rule is not satisfied in those years.

The purpose of the distinction between the two practices is that a person who falls within the longer-term visitors practice is resident but not ordinarily resident. A person within the three years in the UK practice is resident and ordinarily resident.

This practice only applies to someone who comes and remains in the UK "for a purpose (for example, employment)". This is not a requirement for the three years in the UK practice. But it is difficult to see how anyone could come and remain in the UK without having a purpose, so this does not add anything.

3.25 Visitors

HMRC 6 continues:

> If
> [1] neither of the points made applies [not within 183-day rule or remaining 2 years in the UK rule] and
> [2] you can genuinely say that you have come only to visit the UK, the following guidance will apply.

There is no further guidance on what it means to "visit" but this wording allows HMRC such flexibility that they can argue in almost any case where they have any chance of establishing residence that the individual is not on a visit. So the following guidance is of no assistance to taxpayers.

> It is possible that after you first come to the UK to visit, or after you have made a number of visits here, your circumstances change and you become resident and ordinarily resident in the UK. If your circumstances change while you are in the UK you should tell us as soon as possible.

After this admonition, for which (in these terms) there is no statutory

69 See 3.23.1 (Meaning of "remain").
70 Unless the person arrives on 6 April and leaves two years later on 5 April.

authority, HMRC 6 turns to distinguish two types of visitors:

> There are two main[71] types of visitor to the UK:
> • short-term visitors – who are not going to remain in the UK for an extended period and will visit for limited periods in one or more tax years – see paragraph 7.5
> • longer term visitors – who have not come to the UK permanently but have come here indefinitely or for an extended period which might cover several tax years – see paragraph 7.7.

I adopt these labels and refer to "**short-term**" and "**longer-term**" visitors.

> **It does not matter what type of visitor you are. If you are in the UK for 183 days or more in a tax year, you will be resident here in that year. But although you are resident you might be not ordinarily resident which will affect what UK tax you have to pay.**

I am unable to see the difference between the two types of visitor, as so defined, so agree with HMRC that it does not matter what type of visitor you are. But if that is so, why does HMRC 6 draw the distinction?

3.25.1 *One-off visit*

HMRC 6 para 7.5 provides:

> If you are making a single one-off visit to the UK and leave before you have been here for 183 days and do not intend to return, you will not be resident or ordinarily resident in the UK.

3.25.2 *Repeated visit*s

HRMC 6 para 7.5 continues:

> But, if you are going to make regular visits to the UK you need to consider if those visits will mean that you become resident and/or ordinarily resident here.
> Even when you are not in the UK for 183 days during a tax year, if you

71 This suggests that there might be other types of visitor. But HMRC 6 does not take that line of thought any further.

> are making several visits, you must also consider the average number of days that you spend here.
> [1] If, when you first start to visit the UK, you do not know how long you will continue to visit and your visits average 91 days or more per tax year over a four year period, you will be resident and ordinarily resident from the fifth year if you continue to visit.
> [2] You *might* become resident and ordinarily resident in the UK before you have been visiting for four years if:
> • you know, when you start visiting the UK, that your visits here are going to be for an average of 91 days or more, in which case you will be resident and ordinarily resident from 6 April of the tax year in which you first start making your visits.
> • you realise after starting to visit the UK regularly that your visits are going to be for an average of 91 days or more – you will be resident and ordinarily resident from 6 April of that tax year.
> (Emphasis added)

I refer to those within [1] as "**indecisive visitors**". "Indecisive visitors" is not an entirely accurate label for this category of UK residence, but "those who come regularly for more than 90 days average over a five-year period without intending to do so at the outset" is something of a mouthful.

HMRC 6 continues:

> [2] You *might* become resident and ordinarily resident in the UK **before** you have been visiting for four years if:
> • you know, when you start visiting the UK, that your visits here are going to be for an average of 91 days or more, in which case you will be resident and ordinarily resident from 6 April of the tax year in which you first start making your visits.
> • you realise after starting to visit the UK regularly that your visits are going to be for an average of 91 days or more – you will be resident and ordinarily resident from 6 April of that tax year.
> (Emphasis added)

I refer to those who fall in this category as "**intentional visitors**".

A change from the earlier IR20 is that the text now reads *might* whereas IR20 formerly stated that intentional visitors *would* become UK resident. I wonder if this is really what HMRC meant to say. If one takes "might" literally, there is no guidance of when a visitor would or would not be UK resident.

Perhaps the change is due to a problem of the former IR20 identified in the

7th edition of this work:

> This category (intentional visitors) seems again to have the status of provisional and uncertain residence. Suppose T intends to average more than 90 days here over five years, and in year 1 he spends 99 days here; T may think he is UK resident in year 1 but he cannot be sure. If in year 4 T unexpectedly changes his intention and leaves the UK, he retrospectively finds that he is not resident in years 1, 2 and 3 after all! [72]

Perhaps the reason for the change is the emphatic statements elsewhere in HMRC 6 on the non-decisive nature of a day count test.[73]

3.25.3 *Year with no day in UK restarts the clock*

The Inspectors Manual provided at para 45:

> An individual should be regarded as becoming resident if he visits the UK year after year so that his visits become in effect part of his habit of life and are annual visits for a substantial period or periods of time. Normally, an average annual period or periods amounting to 91 days or more should be regarded as substantial and the visits as becoming habitual after four years, *provided that there has been a visit in each of the four years*; such an individual should be regarded as resident for and from the fifth year. (As to the calculation of the three months' average, see IM42, first sub para) Where the visitor's arrangements indicate from the start that regular visits for such substantial periods are contemplated, he would be regarded

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72 For completeness, the text added:
"But possibly one is only expected to calculate the days here up to the year in question, not over a longer average? In practice no problems seem to arise, perhaps because:
(1) taxpayers take the view that 'intention' requires a firm, fixed and irrevocable intention and in practice few if any form such an intention (unless they fall within the three years in the UK practice or satisfy the 183-day rule).
(2) HMRC cannot usually know what a person's intention of future residence is even if (which is rare) the person himself knows. A rule based on subjective intention is in practice unenforceable and so unworkable."

73 HMRC 6 para 2.2 provides:
"There are many different factors which will determine whether you are resident in the UK during a tax year. **With one exception [the 183-day test], it is not simply a question of the number of days you are physically present in the UK during a tax year although this is an important consideration.**"

as resident for and from the first year. In both types of case, if an individual is resident, he is also ordinarily resident.

(Emphasis added)

This is not expressly stated in HMRC 6, though there is a hint of it in HMRC 6 para 7.5 (referring to *regular* visits). Suppose:

(1) Year 1: T spends a relatively short period in the UK (say 30 days).
(2) Years 2–4: T spends much longer in the UK (say 160 days).

Suppose in year 1 T intends to spend the longer periods in years 2–4. Taking HMRC6 literally, T is resident in year 1 (assuming he carries out his intention). But it is considered that unless T resides a sufficient period in year 1, he should not be regarded as resident in that year even if he expects to average 91 days. Where the line is to be drawn is unclear.

3.25.4 *Intention*

The concept of intention can be problematic. What if someone comes to the UK on a visitor's visa, applies for a visa to remain in the UK, but is not sure whether the visa will be obtained? It is suggested that such a person does "intend" to remain in the UK. This is the normal sense of "intention" in law[74] and outside it.[75]

3.25.5 *Calculating annual average visits for short-term visitors rules*

The method of computation for the short-term visitors rules is slightly different from the method used for those leaving the UK.
HMRC 6 provides:

7.6 How to calculate your average visits to the UK
If you need to calculate your annual average visits to the UK, you do so like this:

74 This is consistent with the rule that an illegal immigrant may be UK domiciled: see 2.12 (Refugees and illegal immigrants).

75 See "Intention, Plans, and Practical Reason", Michael Bratman, CSLI Publications, 1999, pp.37, 38, accessible *www.kessler.co.uk*.

$$\frac{\text{Total days visiting the UK x 365}}{\text{Tax years you have visited (in days)}} = \text{annual average visits}$$

After a disclaimer which seems verging on paranoid[76] the text continues with a straightforward example:

> If you were to visit the UK for:
> 80 days in the tax year 2008–09 (365 days in tax year)
> 100 days in the tax year 2009–10 (365 days in tax year)
> 85 days in the tax year 2010–11 (365 days in tax year)
> 105 days in the tax year 2011–12 (366 days in tax year)
> The annual average of your visits would be
> (80+100+85+105) ÷ (365+365+365+366) x 365 = (370 x 365) ÷ 1461 = 92.44 days

3.26 Longer-term visitors

HMRC 6 continues:

> **7.7 Longer term visitors**
> ... It is possible that you will become resident and ordinarily resident in the UK before you have been visiting for four years if:
> • you know when you start visiting the UK that your visits here are going to be for an average of 91 days or more, you will be resident and ordinarily resident from 6 April of the tax year when you first start making your visits.
> • you realise after starting to visit the UK regularly that your visits are going to be for an average of 91 days or more – you will be resident and ordinarily resident from 6 April of that tax year.

This repeats the material in 7.5. HMRC 6 continues:

> **7.7.1 Longer term visitors – residence**
> You are a longer term visitor if you come to the UK but you are not going to remain here permanently or for three years or more (see 7.2). As a longer term visitor you will be resident in the UK from the day that you

76 **"This is an example for illustrative purposes and any calculation you make would be based upon your own circumstances – the day that you actually started to visit the UK and the days that you have been here in the period."** Bold font is original.

> arrive if you have come here for at least two years.

I am unable to follow this and on a first reading it does not make sense. I suspect the cause of this muddle is that the author has adopted wording in former IR20 without consistent or sufficient amendment.

3.27 Ordinary residence

HMRC 6 offers some general comments on ordinary residence:

> **3.2 What does Ordinary Residence mean?**
> Ordinary residence is different from "residence". The word "ordinary" indicates that your residence in the UK is typical for you and not casual. It is important not to confuse ordinary residence with domicile (see part 4). You
> do not have to intend to remain in the UK permanently or indefinitely in order to be ordinarily resident here. It is enough that your residence has all the following attributes.
> • You have come to the UK voluntarily. The fact that you chose to come to the UK at the request of your employer rather than seek another job does not make your presence here involuntary.
> • Your presence here has a settled purpose. This might be for only a limited period, but has enough continuity to be properly described as settled. Business, employment and family all provide a settled purpose, but this list
> is not exhaustive.
> • Your presence in the UK forms part of the regular and habitual mode of your life for the time being. This pattern can include temporary absences from the UK. If you come to live and work in the UK for three years or more then you will have established a regular and habitual mode of life here.
> The pattern of your presence, both here in the UK and overseas, is an important factor when you are deciding if you are ordinarily resident in the UK. You will also need to take into account your reasons for being in the
> UK, your intentions when coming to or leaving the UK and your lifestyle and habits.
> If you have come to the UK voluntarily and for a settled purpose (for example to live and to work for three years or more) you will be ordinarily resident from when you first arrive. If you own or acquire accommodation on a long-term lease in the year you arrive, this may be taken as evidence that you are remaining in the UK for several years and are ordinarily

resident from when you arrive.

If you did not think you were ordinarily resident when you first came to the UK but have been living here for a period covering an entire tax year or more, we expect you to be able to show that you are still not ordinarily resident here, if that is what you claim.

But if, in fact, you actually leave the UK within a year or two of arrival, we will not usually say that you have become ordinarily resident for tax purposes.

Although ordinary residence in the UK is not simply a question of the number of days you are physically present here over a period of time, you can look at the average number of days you are in the UK to get an idea of whether or not you are ordinarily resident here. If you come to the UK regularly and your presence here averages 91 days or more in a tax year over an appropriate period of time, you are likely to be ordinarily resident here. An exception would be if your visits lacked a settled purpose, although the more time you spend in the UK the more likely it is that any residence here has the elements necessary to make you ordinarily resident.

You should calculate your average presence in the UK on the basis shown below. The facts of your particular case will determine the appropriate period over which the calculation should be made, but this should only be more than four full tax years in wholly exceptional circumstances. You should not rely on the calculation as a definitive basis for proving whether or not you are ordinarily resident in the UK.

$$\frac{\text{Total visits to the UK (in days)}}{\text{Relevant tax years (in days)}} \times 365 = \text{annual average visits}$$

Example

This example looks at a period of three tax years as the appropriate period. This in no way indicates that you can be in the UK for three years before you have to consider whether you are ordinary resident.

If you were in the UK for 85 days in 2003–04 (this is a leap year) for 105 days in 2004–05 and for 90 days in 2005–06 then the annual average is:

$$\frac{85+105+90}{366+365+365} \times 365 = 93.2 \text{ days}$$

This example would indicate that you are ordinarily resident in the UK and you should carefully consider your position when Self Assessing your UK ordinary residence.

3.28 Students

HMRC 6 provides one special rule for students, relating to ordinary residence:

> If your home has been abroad and you have come to the UK for less than four years for a period of study or education, you will be resident in the UK while you are here but not ordinarily resident as long as:
> • you do not own or buy accommodation here
> • you do not acquire accommodation here on a lease of three years or more
> • when you leave the UK you are not planning to return here regularly for visits which average 91 days or more in a tax year (to calculate your average visits to the UK – see paragraph 7.6).

It seems odd that a person here for three years to study is not ordinarily resident, but anyone else who is here for three years is ordinarily resident. But there it is. It probably does not matter very often. DTTs often make special provision for students and will need individual consideration.[77]

3.29 Visiting forces

Special reliefs apply to a member of a visiting force of a designated country who is not a British citizen, a British Dependent Territory Citizen, a British National (overseas) or a British Overseas Citizen. See s.833 ITA, s.11 TCGA. HMRC TDSI Guidance Notes provide:

> **4.47 Visiting armed forces**
> Members of visiting armed forces are treated as NOR ... but the residence status of their spouses is determined according to the normal rules.
> A person is a member of a visiting force if he or she is a member of the armed forces of Belgium, Greece, Norway, Germany, France, Canada, Italy, Portugal, Netherlands, United States, Denmark, Luxembourg, Turkey, and is based in the UK, or attached to:
>> Allied Command Atlantic Headquarters; Channel Command; The Channel Committee; Eastern Atlantic Area Command; Supreme Headquarters Allied Forces Europe; North Atlantic Treaty Organisation.

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77 The OECD Model Convention art.20 provides:
"Payments which a student or business apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State."

4.48 Civilian component of visiting armed forces
Members of the civilian components of visiting forces are treated as NOR if they have come to the UK solely because they are a member of such a force. A person is a member of a civilian component of a visiting force if his or her passport contains

- an uncancelled entry made by or on behalf of the sending country stating that the bearer is a member of a civilian component of a visiting force of that country, and
- an uncancelled recognition stamp of the UK Home Office.

Employees of foreign contractors hired in the UK are not members of the civilian component of a visiting force. Their residence status is determined according to the normal rules ....

3.30 Diplomats, UN and EU officials

HMRC TDSI Guidance Notes provide:

4.44 Diplomats
...
The rules for determining whether someone is resident or ordinarily resident in the UK apply to members of a Diplomatic Mission in the same way as they apply to everyone else. There are TDSI guidance notes for diplomats.
4.45 United Nations
The salaries of United Nations workers are usually exempt from income tax but whether or not they are resident or ordinarily resident in the UK is decided in the usual way. ...
4.46 European Community (EC) Officials
... A brief outline of the residence status of officials of the European Community is

- an individual who was NOR in the UK, but was ordinarily resident in another member state before taking up such employment and who is working in a member state will remain NOR in the UK,
- an individual who was not ordinarily resident in any member state before taking up such employment will have his/her residence status determined according to the normal rules, or
- an individual who takes up employment as an official of the EC and who works outside the EC, will have his/her residence status determined according to the normal rules

An individual who was ordinarily resident in the UK before taking up employment as an official of the EC, and who works in a member state will remain ordinarily resident in the UK....

3.31 HMRC forms and rulings

HMRC forms are P85 and P85(S) (leaving the UK) and P86 (arrival in the UK). Residence Guide 1, 2 and 2.2 provides:

> **1.2 Leaving the UK: Forms P85 or P85(S)**
> When you know that an individual is leaving, or has left the UK
> - issue form P85(S) *only* if the individual is a foreign national *and* has been in the UK only for employment here
> - issue form P85 in all other cases.
>
> Send leaflet IR138 with each form P85(S) and P85 issued. (EP8140).
> Keep the completed form as a permanent note.
> You are not likely to dispose of the liabilities of a departing taxpayer immediately or without continuing correspondence.
> Keep personal records as file cases whilst liability is under review. (See EP8139).
> IF THE INDIVIDUAL IS WITHIN SELF ASSESSMENT
> Where it has not been possible to issue form P85 or P85(S) before the Return for the tax year of departure is issued, take the following action
> - issue the form P85 or R85(S) *after* the Return for the year of departure is received as part of a formal enquiry into the Return
> - do not close the enquiry until you are sure that all the queries and action which are necessary after receipt of the completed form have been taken (particularly *not before* you have received CNR advice on residence/domicile where the case needs to be sent to CNR).
>
> ...
> **2.2 Coming to the UK: Form P86**
> When you know that an individual has come to the UK
> - issue a form P86 with leaflet IR139. (See SE42890 and EP8100).
>
> Keep the completed form as a permanent note. It is unlikely that you can deal with a new arrival in the UK as a SRS case before two full tax years have passed.
> IF THE INDIVIDUAL IS WITHIN SELF ASSESSMENT
> Normally form P86 should only be issued during the tax year of arrival in the UK. It may be issued in the tax year following the year of arrival only if a Return for the tax year of arrival has not yet been issued.

Tax Bulletin 29 (June 1997) provides:

> **SA Tax Return**
> The SA tax return requires individuals to tell the Inland Revenue about

their taxable income and capital gains. Because taxation of particular items of income or gains can depend on the individual's residence or domicile, people who regard themselves as not resident, not ordinarily resident or not domiciled in the UK will need to self-certify their status in their SA tax return. Where appropriate, individuals will need to complete the "NON-RESIDENCE ETC" pages NR1 and NR2 and submit these as part of their SA tax return.

"Notes on NON-RESIDENCE ETC" pages are available with the SA tax return. These notes are intended to help individuals to decide their residence status or domicile position. And they will help individuals to complete the "NON-RESIDENCE ETC" pages NR1 and NR2. These notes are particularly comprehensive and include, for example:

- a step-by-step guide to help individuals decide their residence status;
- guidance on how residence and domicile affect an individual's UK tax liability;
- guidance on split year treatment, domicile and double taxation agreements; and
- tables showing the scope of tax liability on different types of income.

Residence rulings

Because individuals will, in appropriate cases, self-certify their residence status on their SA return, there is no need for the Inland Revenue to give a prior "ruling" on an individual's residence status. And so we have changed our procedures regarding such residence "rulings". We will continue to ask individuals for information about their residence or ordinary residence status. But neither tax offices nor Financial Intermediaries and Claims Office (FICO) intend to provide residence "rulings" as we have done in the past.

Given that individuals will decide what they regard their residence status to be, we propose to end our existing practice of advising an individual in the fourth year of the consequences of continuing to make regular visits to the UK exceeding an average of 90 days per year.

Residence certificates

Tax offices will continue to certify residence - for example, certifying a formal claim form issued to the individual by the foreign tax authority - to enable UK resident individuals to obtain relief from foreign tax under the terms of a Double Taxation Agreement.

Forms P85, P85(S) and P86

We recognise that an individual may give us information about his/her residence position, for example on form P85 or form P86. We will use this information:

- to give an accurate PAYE code to someone arriving in the UK to take up employment; or

- to make an in-year repayment to someone leaving the UK who claims split year treatment.

In these and similar situations, we will normally act on the basis of the information the individual provides and treat the residence position accordingly. Tax offices will be prepared to tell individuals how the residence position has been treated for coding or repayment purposes. We do not regard that as deciding the individual's residence status. In appropriate cases, we may make enquiries into an individual's residence status as part of an enquiry into the return once it has been received.[78]

3.32 The future

HMRC 6 shows some signs of being a document prepared in haste. I infer that a decision was made to bring it out on 31 March because it could not have been published after 6 April if it was to take effect from 2009/10. One foreseeable development is a revised version of HMRC 6.

In the longer term, the pressure for a proper statutory definition of residence is likely to prove irresistable.

The obstacles to reform seems to be as follows. First, no-one can agree exactly what the residence test should be. This should not be a problem. Any test must be to some extent arbitrary, but that is often the case in tax.

Second, any reform of residence which is part of a package reforming the remittance basis is bound to meet a hostile reception. This was perhaps the rock which sank the 1988 proposals, but should not be a problem if residence is addressed in isolation, particularly after the 2008 reform of foreign domicile taxation.

Thirdly, the current concept of residence is much wider than in most other

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78 The same point is made in the Double Taxation Relief Manual which provides:

> "**811. Determination of UK residence – individuals**
>
> ... For years from 1996–97, individuals within Self Assessment are able to certify their own residence status on their SA tax return. Residence 'rulings' as such will no longer be provided as a matter of course by the Centre for Non-residents (previously FICO). Inspectors who are required to certify that an individual is UK resident for the purposes of a treaty claim should act upon any relevant information provided by the taxpayer for example on forms P85 or P86 or on the most recent SA tax return, but the provision of a certificate on that basis does not amount to the making of a formal determination of residence status. It remains open to Inspectors, in appropriate cases, to enquire into an individual's residence status as part of an enquiry into a SA tax return once it has been received."

countries.[79] The absence of a proper definition tends to conceal that fact. To enact a 91-day test might cost tax, though much depends on the details and on how taxpayers chose to behave in the light of the current vague state of the law, when they cannot tell if they are resident or not.

3.33 Tax reason for becoming non-resident

In *Reed v Clark* the taxpayer had carefully organised his "year out" to reduce his tax liability but that was irrelevant:

> Residence abroad for a carefully chosen limited period of work there ... is no less residence abroad for that period because the major reason for it was the avoidance[80] of tax. Likewise with ordinary residence.[81]

3.34 Commentary

3.34.1 *Should we abolish ordinary residence?*

The concept of ordinary residence is of relatively small importance in tax and there have been calls for its abolition.[82] Abolition would be a gain in simplicity and few would be affected by the change. That is not enough to justify the abolition of ordinary residence: one would need to go through every occasion where ordinary residence mattered and ask whether the change was justified. In some cases, ordinary residence is enshrined in international agreements or in existing Government undertakings (e.g. a promise not to tax non-ordinary residents on exempt gilts) and that could not easily be abolished. It is suggested that a useful distinction can be drawn between those resident for a year or two and those resident for a

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79 After the 2008 reforms I would not be surprised if it was the widest definition of residence in the world, though I am not in a position to confirm that.

80 As to whether "avoidance" is the right term to use here, see 21.7 ("Avoidance", "mitigation", "tax reduction", "evasion": introduction). Contrast the Special Commissioner in *Shepherd v IRC* 78 TC 389 at [62]: "Although the Appellant's intention in going to Cyprus was to mitigate tax, I do not regard that as a relevant factor in deciding whether he was resident in the UK."

81 58 TC 528 at 556.

82 David Jeffrey, *Taxation*, 6 December 2001, p.254; STEP submission on 2003 Background Paper on Domicile & Residence. Ordinary residence is also unsatisfactorily vague but (like residence) that could quite easily be put right by a statutory definition.

longer term, and ordinary residence (if properly defined) does have a useful role to play in a fair tax system.

3.35 Residence of companies

Residence of companies is a subject which deserves to be addressed in length and depth. I can omit it here as it is well covered elsewhere.[83]

83 For HMRC views see SP 1/90 and the International Tax Handbook chapters 3 and 4. For an important statement of judicial views, see "Control of Special Purpose Vehicles" (John Chadwick) [2007] Jersey & Guernsey Law Review 153 accessible *www.jerseylaw.je/Publications/jerseylawreview*. For general studies, see Corporate Residence and International Taxation (Robert Couzin, IBFD 2002); Stephen Brandon QC's *Taxation of Non-UK Companies and their Shareholders* (Key Haven Publications, 2002).

CHAPTER FOUR

RESIDENCE OF TRUSTEES

4.1 Trustee residence – Introduction

Trustee[1] residence (like individual residence) is fundamental to the territorial limitations of IT and CGT.

From 2007/08 there is one main definition of trustee residence, which is the same for income tax and CGT.[2]

Under the FA 2006, the wording was exactly the same (though the provisions were set out twice, once in ICTA and again in the TCGA). But the ITA has repealed the ICTA provisions and recast them in its own plain English style, so the wording of the IT rules is often different from the CGT rules. In this chapter I set out both sets of provisions, although the effect of the rules is the same. If (as the professional bodies asked at the time) the 2006 reform had been put back to 2007, this complication would have been avoided. But there it is.

The current rules adopt proposals originally made in the Trusts Consultative Document (1991) Chapter 10. This is worth reading as it reflects the background to the current rules.

The law before 2007/08 provided that a UK professional trustee of a trust with a non-resident, non-domiciled settlor was regarded as non-resident. This thoroughly sensible provision allowed UK professional trustees to act without attempting to tax them. The object was to allow the UK to compete on equal tax terms with foreign trustees. The rule also helped keep administrative expenses down. The reason given for its abolition was that the DTI had advised the rule breached EU restrictions on State Aid. HMRC have refused to disclose the DTI advice which may lead one

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1 Strictly, one should refer to the residence of trustees, not the residence of a trust, but in practice the two expressions are used synonymously.

2 For IHT see 4.13 (Trustee residence for IHT).

to speculate as to whether this is a true reason or an excuse. An application under the Freedom of Information Act is outstanding. This may be resolved by the time of the next edition of this book, though damage to the UK trustee industry will by then be done.

Different rules apply to PRs.[3]

4.2 Identifying trustees

One needs first of all to identify the trustees. This is normally but not invariably straightforward. See 4.12 (UK protectors and trustee residence) on whether a protector may be a trustee.

What if there has been an invalid appointment of new trustees, and the trust property has been transferred to the invalidly-appointed trustees? The law distinguishes between:

(1) a validly appointed trustee, and
(2) an invalidly appointed trustee who is not the proper owner and administrator of the trust assets, but who is of course subject to the duty to return the trust fund to the correct trustees, and may become a trustee *de son tort.*

What confuses matters is that the term "trustee" is sometimes (but not always) used to describe someone in category (2).[4] But it is considered that such a person is not a "trustee" for tax purposes.[5]

Next one must identify the trustees' actual place of residence in their personal capacities, applying the tests of individual/corporate residence to each individual (or corporate) trustee.

For the position where trustees change residence during a year, see 6.15 (Income tax on trustees).

3 See 56.4 (Residence and domicile of PRs for CGT) and 57.2 (Residence of PRs for IT)

4 See R.C. Nolan's learned article "Equitable Property" [2006] LQR 232.

5 For CGT this is clearer as an invalidly appointed trustee would be a nominee within s.60 TCGA, but the same would apply for IT. In *Jasmine Trustees v Wells & Hind* [2007] STC 660 it was held that invalidly appointed trustees were "trustees" but were not "trustees of the settlement", which is another route to the same destination.

4.3 Trustees treated as single and distinct person

Section 474(1) ITA provides:[6]

> For the purposes of the Income Tax Acts (except where the context otherwise requires), the trustees of a settlement are together treated as if they were a single person (distinct from the persons who are the trustees of the settlement from time to time).

4.4 Trustee residence for income tax and CGT

Section 475 ITA provides:

> (1) This section applies for income tax purposes and explains how to work out, in relation to the trustees of a settlement—
> (a) whether or not the single person mentioned in section 474(1) is UK resident, and
> (b) whether or not that person is ordinarily UK resident.
> (2) If at a time either condition A or condition B is met, then at that time the single person is both UK resident and ordinarily UK resident.
> (3) If at a time neither condition A nor condition B is met, then at that time the single person is both non-UK resident and not ordinarily UK resident.

There are therefore two circumstances in which trustees are UK resident: Condition A and Condition B. In the CGT legislation these are called Condition 1 and Condition 2. I refer to them as "**trustee residence conditions A and B**", to avoid confusion with the myriad other conditions in ITA.

Section 69 TCGA provides:

> **69 Trustees of settlements**
> (1) For the purposes of this Act the trustees of a settlement shall, unless the context otherwise requires, together be treated as if they were a single person (distinct from the persons who are trustees of the settlement from time to time).
> (2) The deemed person referred to in subsection (1) shall be treated for the purposes of this Act as resident and ordinarily resident in the UK at

6 The CGT equivalent is s.69(1)(3) TCGA.

> any time when a condition in subsection (2A) or (2B) is satisfied.

The statutory expression “not resident or not ordinarily resident” is a clumsy one. As in the last chapter, I shall abbreviate it to “non-resident” and leave “ordinarily resident” to be understood.

4.5 Trustee residence condition A: all trustees UK resident

Section 475(4) ITA provides:

> Condition A is met at a time if, at that time, all the persons who are trustees of the settlement are UK resident.

Similarly for CGT, s.69(2A) TCGA provides:

> Condition 1 is that all the trustees are resident in the UK.

If all the trustees are UK resident, the trust is UK resident; conversely if all the trustees are not resident in the UK, then the trust is non-resident.

4.6 Trustee residence condition B: mixed resident trustees

Condition B deals with the position of trustees of mixed residence. Section 475(5) ITA provides:

> Condition B is met at a time if at that time—
> (a) at least one person who is a trustee of the settlement is UK resident and at least one such person is non-UK resident, and
> (b) a settlor in relation to the settlement meets condition C (see section 476).

I refer to condition C as “**trustee residence condition C**”.
Similarly for CGT, s.69 TCGA provides:

> (2B) Condition 2 is that:
> (a) at least one trustee is resident in the UK,
> (b) at least one is not resident in the UK, and
> (c) a settlor in relation to the settlement was resident, ordinarily resident or domiciled in the UK at a time which is a relevant time in relation to him.

(2C) In subsection (2B) 'relevant time' in relation to a settlor—
(a) means where the settlement arose on the settlor's death (whether by will, intestacy or otherwise), the time immediately before his death, and
(b) in any other case, a time when the settlor made the settlement (or was treated for the purposes of this Act as making the settlement).

4.7 Trustee residence condition C

Condition C corresponds to the CGT relevant time rule. Section 476 ITA provides:

> **How to work out whether settlor meets condition C**
> (1) This section applies for the purpose of working out whether a settlor ("S") in relation to a settlement meets condition C at a time.

Section 476(2) ITA deals with testamentary trusts:

> If—
> (a) the settlement arose on S's death (whether by S's will, on S's intestacy or in any other way), and
> (b) immediately before S's death, S was UK resident, ordinarily UK resident or domiciled in the UK,
> then S meets condition C from the time of S's death until S ceases to be a settlor in relation to the settlement.

Section 476(3) ITA deals with lifetime trusts:

> If—
> (a) the settlement is not within subsection (2)(a), and
> (b) at a time when S made the settlement (or is treated for the purposes of the Income Tax Acts as making the settlement), S was UK resident, ordinarily UK resident or domiciled in the UK,
> then S meets condition C from that time until S ceases to be a settlor in relation to the settlement.

For the purposes of discussion it is convenient to have some terminology and I coin the following terms:

(1) A "**UK-linked settlor**" is one within Condition C, i.e. (in short) who is resident, ordinarily resident or domiciled in the UK when he made

the settlement.

(2) A "**UK-linked trust**" is one where the settlor (or a settlor) was UK-linked when he made the settlement.

(3) A trust has "**mixed resident trustees**" if some trustees are UK resident and some are not.

Thus (in my terminology) a trust with mixed resident trustees is UK resident if it is a UK-linked trust; conversely it is non-resident if it is not a UK-linked trust.

4.7.1 *Identifying settlor and date of provision: tainting*

In trusts with mixed resident trustees, it is necessary to identify the settlor(s)[7] and to ascertain when the settlor(s) provide trust property.

A trust whose settlor is not UK-linked may have some UK trustees (as long as they are not the sole trustees). In that case, however, one must take care that no *other* UK-linked person provides even a nominal amount of funds because that will make him a co-settlor and the trust UK resident. This is known as "tainting" the trust.[8]

Suppose:

(1) Year 1: the settlor makes a trust when he is not UK resident;

(2) Year 2: the *same* settlor comes to the UK and adds property to the settlement.

It is arguable that the time that S made the settlement was year 1; in year 2 he does not make a separate settlement; so the settlement is not UK-linked. However one should not plan on that basis.

Suppose:

(1) A settlor while abroad lends money to a trust with mixed resident trustees. The loan is interest free and repayable on demand.

(2) The settlor later comes to the UK and leaves the loan outstanding.[9]

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7 See 58.1 (Who is the settlor?).

8 See 58.3.10 (Tainting).

9 If the loan is to a company held by the trust, then even if the settlor does provide property by leaving the loan outstanding it did not matter for the CGT rules before 6 April 2007 as the settlor has not provided settled property (so long as company

It is considered that the settlor has provided property by leaving the loan outstanding but only if he does so deliberately.[10]

4.7.2 *Split years*

Suppose a settlor makes a trust with mixed resident trustees and becomes UK resident later but in the same tax year. Since the reference is to residence at the (specific) time when S made the settlement, this is not a UK-linked trust.

4.8 Accidental residence: a trap

A trust may become UK resident if:

(1) its sole trustee becomes UK resident; or
(2) any trustee becomes UK resident and it is a UK-linked trust.

The consequences of a trust becoming UK resident will be disastrous for CGT and (except for IP trusts) for IT. Before 6 April 2007 this rule was mitigated for CGT, because a trust would not become UK resident for CGT if a trustee became resident for one year only.[11] That defence has been withdrawn. So it is essential to resign trusteeship before becoming UK resident if (1) a sole trustee or (2) trustee of a UK-linked trust. This includes trusteeships of foreign law charitable trusts.

This state of affairs is deliberate, for the 1991 consultative document discussed a relief for temporary resident trustees, but suggested, implausibly, that the problem was not significant. In practice, in cases of unfairness, the problem will be overlooked or ignored by non-compliant taxpayers, and HMRC may not spot it or turn a blind eye.

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assets are not transferred to the trust). But from 2007 this argument does not apply because the question is not whether the settlor provides settled property, it is whether the settlor provides property for the purposes of the settlement. See 58.14 (Provision of property for company held by trust).

10 See 58.16 (Interest-free or back-to-back loan).

11 See the 4th edition of this book para 5.6.1 (Administration "ordinarily" carried on outside UK).

4.9 Sub-funds

It is common for one trust to be divided into separate funds ("sub-funds") and it is possible (though not common) for the sub-funds to have separate trustees. Section 474(2) ITA provides:

> If different parts of the settled property in relation to a settlement are vested in different bodies[12] of trustees, subsection (1) and sections 475 and 476 apply in relation to the different bodies as if they were all one body.

Thus the trust is UK resident unless the trustees of the sub-funds jointly meet the trustee residence conditions.

Section 474(3) deals with Settled Land Act settlements:

> The cases covered by subsection (2) include cases where settled land (within the meaning of the Settled Land Act 1925) is vested in the tenant for life and investments representing capital money are vested in the trustees of the settlement.[13]

Settled Land Act settlements are obsolescent and not considered here.

The FA 2006 introduced a regime for sub-funds where there has been a sub-fund election. The regime is supposed to be a relief, but its conditions are so strict that it is almost never used. In the first year of the sub-fund regime, only *eight* sub-fund elections were made.[14] The lengthy and complex provisions are dead letter tax law. There is a special residence rule for trusts subject to a sub-fund election: see s.477 ITA. In the circumstances it is not necessary to consider this here.

4.10 Transfer between settlements

Section 476(4) ITA deals with transfers between settlements:

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12 The drafter has here retained the expression "body of trustees" which has elsewhere been deleted from the legislation, but it does not matter.

13 The CGT equivalent is s.69(3) TCGA.

14 HMRC correspondence to the author.

> (4) Further, if—
> (a) there is a transfer of property in relation to which section 471 applies,
> (b) S is a settlor in relation to settlement 2 as a result of that section, and
> (c) immediately before the disposal by the trustees of settlement 1, S meets condition C as a settlor in relation to settlement 1 as a result of subsection (2) or (3) or this subsection,
>
> then S meets condition C as a settlor in relation to settlement 2 from the time S becomes such a settlor until S ceases to be such a settlor.
> (5) "Settlement 1" and "settlement 2" are to be read in accordance with section 470(1).

For CGT, the equivalent is the last paragraph of s.69(2C) TCGA:

> and, in the case of a transfer of property from Settlement 1 to Settlement 2 in relation to which s.68B applies, "relevant time" in relation to a settlor of the transferred property in respect of Settlement 2 includes any time which, immediately before the time of the disposal by the trustees of Settlement 1, was a relevant time in relation to that settlor in respect of Settlement 1.

4.11 Permanent establishment residence rule

Section 475(6) ITA provides:[15]

> If at a time a person ("T") who is a trustee of the settlement acts as trustee in the course of a business which T carries on in the UK through a branch, agency or permanent establishment there, then for the purposes of subsections (4) and (5) assume that T is UK resident at that time.

I refer to this as the "**PE residence rule**". The Trusts Consultative Document (1991) explains the reason:

> **UK branches of foreign trust corporations**
> 10.21 The income tax test might need to be modified for certain foreign corporate trustees. A trust company, resident outside the UK, could be the sole trustee of a trust which was dealt with in this country by the

15 The CGT equivalent is s.69(2D) TCGA.

> company's UK branch. It would not be appropriate if such a trust were treated as non-resident, because it would then be taxed more favourably than a similar trust dealt with by a branch of a UK corporate trustee, or by some other UK professional. That could both lead to a loss of tax and put UK professionals at a competitive disadvantage. It is therefore suggested that the UK branch of a foreign trustee should be treated as a trustee resident in the UK for the purpose of the common residence test.

This rule applies if:

(1) A trustee carries on a business
(2) It carries on business in the UK
(3) It carries on business through a branch, agency or PE in the UK.
(4) It acts as trustee in the course of that business.

HMRC published 17 pages of draft guidance on 27 January 2009[16] but have not issued final guidance at the time that this book went to print.

4.11.1 *"A business"*

The PE residence rule only applies if the trustee carries on a business. A trustee who does not charge (such as a family's own trustee company) does not carry on a business. This may offer a solution to the PE problem of the PE residence rule.

4.11.2 *"Acting as trustee in the course of a business"*

The business must be (or include) the business of acting as trustee.

4.11.3 *"Business carried on in the UK"*

What if T carries on business partly in the UK and partly elsewhere? It is suggested that T carries on business in the UK, so if the UK part is carried on through a PE, T is deemed UK resident. If this is right, the rule lacks all proportionality. There is no *de minimis* rule. If a tiny part of T's trust

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16 "HMRC Trustee Residence Guidance accessible *www.hmrc.gov.uk/cnr/trust-res-dr-guidance.pdf.*

business is carried on through a UK PE, the entire trust may become UK resident. As to whether a business is partly carried on in the UK, see 14.3 (Non-resident trader rules), but if the business is carried on through a PE in the UK, there must be a business carried on in the UK.

4.11.4 *Branch/agency and PE*

In tax, the concept PE is used for companies and "branch or agency" is used for individuals.[17] It is considered that one asks whether an individual trustee is carrying on a trustee business through a branch or agency. One asks whether a corporate trustee is carrying on a trustee business through a PE. One does not ask if an individual has a PE, or if a company has a branch or agency. HMRC agree:

> a non-resident company is within the provisions only if it has a UK permanent establishment, and ... "branch" or "agency" relates only to a non-corporate person.[18]

In practice it is rare for an offshore trust to have individuals as trustees, and where individuals do act, they do not usually do so "in the course of business". Accordingly, the question will normally be whether a corporate trustee has a PE: branch/agency will not normally arise. Since branch/agency is a somewhat undeveloped concept that is probably just as well.[19]

4.11.5 *One trustee of several trusts*

What is the position if a person is trustee of several trusts and he acts as trustee through a UK branch for one trust, but not the others? It is considered that only that one trust is UK resident. This view makes better sense in the context and is supported by the rule that trustees are a separate person from the person who is actually trustee.

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17 For discussion of these concepts, see 14.3 (Non-resident trader); and 64.2 (Meaning of "permanent establishment").

18 HMRC letter to STEP 8 January 2007 accessible to STEP members on *www.step.org/showarticle.pl?id=1791*.

19 See 64.11 (Meaning of "branch or agency").

4.11.6 *Several trustees of one trust*

Suppose:

(1) a trust has two trustees, T1 and T2.
(2) T1 is deemed UK resident but T2 is not (e.g. T2 is an individual who does not carry on business).

This is treated as a trust with mixed resident trustees; see 4.6 (Trustee residence condition B: mixed resident trustees). So where a trust does not have a UK-linked settlor, the appointment of a co-trustee who does not carry on trustee business would solve the difficulty posed by the PE residence rule.

4.11.7 *When is there a UK PE?*

It is suggested that the position is as follows:

> (1) The UK parent or UK group members in the same group as the trustees have office space in the UK and typically permit visiting directors or employees of the non-resident trustee company to use their meeting rooms or other office facilities (e.g. telephones, computers or faxes). Such use is made when the director or employee concerned is in the UK on occasional visits for the purpose of meeting the settlor or beneficiaries or professional advisers. Such professional advisers may be independent practitioners or employees of the UK parent or other UK group members.

Occasional visits to meet the settlor/beneficiaries cannot constitute a PE, which requires regularity.[20]

> (2) The UK parent or UK group members provide such office accommodation on an occasional basis to enable the employee of the non-resident trustee company to meet prospective settlors or business contacts for the purposes of selling trustee services.
> (3) The non-resident trustee company has a director or other employee who is resident in the UK. This individual may also be an

20 See 64.3.2 (Time condition).

employee or director of UK resident group members. The group provides office accommodation in the UK to the individual concerned. His role is to market the business of the non-resident trustee company in the UK and meet the prospective settlors and other business contacts for this purpose. He also meets settlors and beneficiaries of existing trusts.

Marketing to prospective settlors is not trading in the UK because no trust at that time exists.

(4) The non-resident trustee company contracts back office service such as accounting and tax compliance to UK group members on commercial terms.
(5) The non-resident trustee company contracts with UK group members for investment advice or management on commercial terms.

UK group companies providing accounting tax or investment services on commercial terms do not amount to trading in the UK (or a PE) and the UK group member is clearly not a PE.[21]

4.11.8 *Arm's length services*

HMRC say:

> I can confirm that our interpretation of the rules is that the provision of services on an arms length basis would not cause non-UK trustees to have a permanent establishment and therefore would not make the non-resident trustee UK resident.
> More specifically, this would include where services are carried out by a subsidiary on a fully arms length basis, such as:
> - maintaining the financial or accounting records
> - preparation of accounts
> - preparation and submission of tax returns for any settlement by a separate entity within the organisation contracting at arms length terms.
>
> Provided the services are contracted (at arms length terms) HMRC would not consider this constitutes a permanent establishment as the UK

21 See 64.7 (PE: preparatory and auxiliary activities).

company will be rendering a service to the trust. Therefore, these activities would not cause the non-UK trustees to have a permanent establishment in the UK and the non-UK trustee is not made resident by s.69(2D) TCGA 1992.[22]

4.12 UK protector and trustee residence

It is normal practice to appoint a "protector"[23] who has power:

(1) to consent to certain key matters of trust administration; and
(2) to appoint and dismiss trustees.

The protector may be a UK resident. A protector could not be regarded as a trustee[24] and so his actual residence is irrelevant in ascertaining the

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22 Extract from letter dated 18 July 2007 accessible *www.step.org/attach.pl/1914/3631/Trustee/Residence/ALS*.

23 On trust law and drafting aspects of protectors, see *Drafting Trusts and Will Trusts*, James Kessler QC, Sweet & Maxwell, 8th ed, para 7.29.

24 Some have doubted this but in the author's view the position is clear. *Re Marshall* [1945] Ch 21 held that trustees for the purpose of the obsolescent Settled Land Act 1925 are "trustees" for the purpose of the Judicial Trustee Act 1896. Although trust land is not vested in SLA trustees, capital money and investments other than land are vested in them, and *for this reason* they were held to be trustees. In *Manoogian v Sonsino* [2002] WTLR 989; 5 ITELR 125 a settlement provided:

> "... the Bank shall make such investments as may from time to time be particularly and specifically directed to be made of it in writing from time to time by the Armenian Patriarchate of Jerusalem."

The Patriarch was not a trustee:

> "His position is analogous to powers of a life tenant under a conventional strict settlement. The life tenant is often given powers to possess land, direct investments and so on, but none of those things make him a trustee of the settlement."

In *Clay v Clay* [2001] HCA 9 (accessible on *www.austlii.org*) the High Court of Australia similarly held that a guardian was not a trustee. Underhill and Hayton, *Law Relating to Trusts and Trustees*, 17th ed, 2006, p.1.78, takes the same view: "Because the protector merely has powers vested in him and not trust property he is not a trustee".

It might be a different matter if the protector's powers extend beyond those traditionally given to a protector. One could imagine a trust deed under which:

(1) persons named "trustees" held legal title to property; and
(2) a person named (or mis-named) "protector" held all the administrative and dispositive powers normally given to trustees.

This case (depending on the drafting) might be equivalent to the common situation actual residence of the trustees in their personal capacities.

One must take care that the protector is not a permanent establishment of the trustees. This will not normally be the case, but it might be if the protector is given unusually wide powers.

4.13 Trustee residence for IHT

Trustee residence is not very important for IHT but there are a few cases where the concept is used.

IHT uses a definition of trustee residence which is different from the IT/CGT definition.

For the (somewhat academic) relief for foreign currency bank accounts, s. 157(4) IHTA provides:

> For the purposes of this section—
> (a) the question whether a person is resident or ordinarily resident in the UK shall, subject to paragraph (b) below, be determined as for the purposes of income tax; but
> (b) the trustees of a settlement shall be regarded as not resident or ordinarily resident in the UK unless the general administration of the settlement is ordinarily carried on in the UK and the trustees or a majority of them (and, where there is more than one class of trustees, a majority of each class) are resident and ordinarily resident there.

For the purposes of s.218 IHTA (duty of disclosure relating to non-resident trust), s.218(3) IHTA provides:

> For the purposes of this section trustees of a settlement shall be regarded

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where trust property is vested in nominees. In such a case no one suggests that the nominees are "trustees" for the purposes of the trust residence rule. Although the legal title may not be vested in the trustees, the trustees have the right to call for it. Alternatively (depending on the drafting) the case may be equivalent to the situation where custodian trustees hold the trust fund on behalf of managing trustees under s.4 Public Trustee Act 1906. In such a situation, the (so-called) protector would be a trustee. This is hypothetical – I have never seen it in practice – but worth mentioning as warning of the problems which might arise if the powers of a UK resident protector were unduly extended.

Many offshore Trust Laws state expressly that a protector is not a trustee; but (i) that only states what would in principle be the position, and (ii) that could not be determinative of the meaning of "trustee" in a UK statute.

> as not resident in the UK unless the general administration of the settlement is ordinarily carried on in the UK and the trustees or a majority of them (and, where there is more than one class of trustees, a majority of each class) are for the time being resident in the UK.

For the purposes of s.201 IHTA (collection of tax due from non-resident trust from settlor), s.201(5) IHTA makes identical provision.[25]

For the question of where the administration of a settlement is carried on, see the 5th edition of this book para 5.6. There are various interesting points that could in theory arise under these definitions, but I doubt if any of them will ever arise in practice.

4.13.1 *Commentary*

IHT trustee residence is something of a mess: essentially the same definition is repeated four times.

There is no need to have a separate definition of trustee residence for IHT at all, and if we need to keep the concept of trustee residence, it would be best to switch to the IT/CGT definition. Failing that, a single standard definition applying for all IHT purposes would be a small improvement.

4.14 Commentary: Let's abolish the relevance of trustee residence

Residence is a sensible connecting factor for individuals: everyone will accept that a person who is UK resident should to some extent at least be subject to UK tax. Residence of trustees is a matter which can be chosen by judicious appointment of trustees, and makes little sense as a connecting factor in the taxation of trusts.

An alternative (and, I suggest, a better) system would be that trusts pay IT and CGT regardless of the residence of the trustees in relation to property provided by a UK domiciled or resident settlor. Conversely, trusts should be exempt from CGT and IT on foreign income in relation to property provided by foreign domiciled non-resident settlors. This is the basis of trust taxation in Canada, New Zealand and, I suspect, most other common law jurisdictions. It is also the basis of IHT. Of course, domicile and

25 For completeness, the same definition is set out yet again in the IHT (Delivery of Accounts) (Excepted Settlements) Regulations 2008.

residence of the settlor are not perfect connecting factors. Such a thing does not exist. International families can sometimes break the link by tax planning.[26] But the mad anti-avoidance structure of ss.86 to 98 TCGA, bolstered (supposedly) by Schs 4A to 5, can be replaced with one based on s.731 ITA. The reform, like any, would bring winners and losers but the overall result could — if properly drafted — be a system which was fairer, simpler and much more effective.

26 See 58.34 (Planning to create trust with foreign domiciled settlor).

CHAPTER FIVE

TREATY-RESIDENCE

5.1 Introduction

This chapter considers residence as defined for the purposes the OECD Model Treaty.

The concept is distinct from residence for UK tax purposes. To avoid confusion it is essential to have distinct terminology. I use the term **"treaty-residence"** and when it is necessary to distinguish the two, I refer to residence for UK tax purposes as "**domestic-law residence"** and someone who is UK resident for UK tax purposes as **"domestic-law UK resident."**

In any particular case it will be necessary to review the terms of the actual treaty concerned.

For a discussion of treaty-residence, see OTR Vol 8, p.189 (Robert Venables QC).

5.2 Starting point

Article 4 OECD Model Convention provides:

> 1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax[1] therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital

1 i.e. income tax or CGT.

situated therein.

So far as UK tax is concerned, this means (in general) a person who is domestic-law UK resident though it would also include the (probably theoretical) case of someone who is domestic-law ordinarily resident but not domestic-law resident.

5.3 Tie-breaker test for individuals

So far, it would be possible that a person is treaty-resident in both contracting states, but there follow a series of tie-breaker tests, in order of priority:
(1) permanent home
(2) centre of vital interests
(3) habitual abode
(4) nationality
(5) mutual agreement.

The INT Manual provides:

> **154020. Dual residents**
> ... Although the agreement overrides some of the normal consequences of being a UK resident, it does not, in the case of an individual, override the fact of UK residence itself for purely domestic law purposes. Even though an individual may be resident for agreement purposes elsewhere, he (as a resident of the UK for UK tax purposes) still has to complete returns and fulfil any similar obligations imposed by the Taxes Management Act. He will also remain entitled to any personal allowances which may be due on account of his UK residence status.
> The type of individual dual resident most frequently encountered is the foreign executive employed by a multinational group who is seconded to the UK for a period. If the UK assignment is relatively short the individual may still be regarded as resident in his home State under its tax laws while having acquired UK residence status under the domestic rules administered by the Centre for Non-Residents, Bootle. Frequently, the fact of dual residence only comes to light when a claim is made for exemption of employment income from UK tax in accordance with an agreement Article of the type described at DT1920. These taxpayers, like other dual resident individuals who claim an agreement benefit available to residents of an agreement partner, should be dealt with as outlined at INTM154040.
> Substantial amounts of tax often turn on the determination of dual residence problems and it is important that a claim to be 'treaty resident' in the overseas country is not accepted uncritically. Revenue Policy, International, External

> Relations Group (Advisory) should be consulted in any case where there is doubt or difficulty in relation to the claim made. In these cases, it is important that the basis on which treaty residence in the other State is claimed is clear. All the relevant facts relating to that claim need to be assembled in order for a proper judgement to be made.

5.4 Permanent home

Article 4 OECD Model Convention provides:

> 2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:
> a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him;

For convenience of exposition it would be helpful to consider separately the concepts of:

(1) "home"
(2) "permanent"
(3) "available"

But this neat analysis is not practical: to some extent the three terms interact, for a property which is not "available" or "permanent" is less likely to be a "home".

5.4.1 *"Home"*

The OECD commentary provides:

> 13 As regards the concept of home, it should be observed that any form of home may be taken into account (house or apartment belonging to or rented by the individual, rented furnished room).

The ordinary meaning of the word "home" is discussed in *Re Y* [1985] Fam. 136 at p.140.

> 'Home' is defined thus in the Shorter Oxford English Dictionary:
> "A dwelling-place, house, abode: the fixed residence of a family or household; one's own house; the dwelling in which one

> habitually lives, or which one regards as one's proper abode."
>
> It is a definition which, in my judgment, contains the essential elements of a "home" as it is to be understood for present purposes.

One fundamental characteristic of a "home" is that one lives there. As Sheldon J said:

> I have no doubt that any individual may have two homes; but each, in my judgment, to be properly so called, must comprise some element of regular occupation (whether past, present, or intended for the future, even if intermittent), with some degree of permanency, based upon some right of occupation whenever it is required, where, in the words of Kekewich J. in *Re Estlin*, *Prichard v. Thomas* (1903) 72 L.J. Ch. 687, 689, "You find the comforts of what is known as home"; the fixed residence of a family or household.

However, the *amount* of time that one spends in a place may not shed much light on whether that place is a "home". One can spend relatively little time in a place which is still home. This point arose in *Frost v Feltham* 55 TC 10. The issue in that case was to identify the taxpayer's "main residence". The expression "main residence" is somewhat narrower than "home", for a "main residence" must almost necessarily be a "home" but a "home" need not be a "main residence". In that case, Mr and Mrs Feltham spent periods of two or three days in each month at a property called "Mount Severn". They spent the rest of the time in "The White Horse", a public house of which Mr Feltham was licensee. Nourse J noted that "viewed in isolation those are not long periods of time to spend at a house which can properly be described as the principal or more important residence of the persons concerned". Nevertheless, Mount Severn was held to be their principal residence:

> A residence is a place where somebody lives, and it is clear that Mr Feltham lived for the greater part of the year at the White Horse, Roydon. Therefore, he could not have used Mount Severn as his only residence. But that does not at all mean that he could not have used it as his principal or more important residence, even though he spent very little time there. If someone lives in two houses the question, which does he use as the principal or more important one, cannot be determined solely by reference to the way in which he divides his time between the two. I can test that by reference to an example far removed

> from the facts of this case and the conditions of our own times. In his "Lives of the Lord Chancellors" Lord Campbell tells how Lord Eldon was often prevented by the burdens of his office from visiting his estate at Encombe in Dorset for long periods at a time. Sometimes he was only able to get down there for three weeks or so in the year, for the partridge shooting in September. True it was that Lord Eldon also had a good house in Hamilton Place, but it could not really have been suggested that he did not use Encombe as his principal or more important residence.

A second fundamental characteristic of a "home" is identified in the Law Commission paper on the law of domicile. The Law Commission observes that:

> "Home" conveys ... the combined ideas of physical presence and emotional link.[2]

The folk-saying is true that "home is where the heart is". In the dictionary definition which Sheldon J approved, home is a place which one *regards* as one's proper abode. The views of the individual himself are therefore highly relevant. It would be, to put it at its lowest, surprising if a place which an individual actually regarded as his home was not in fact his home. The views of the parties as to which property was the main residence were held to be relevant in *Frost v Feltham*; see 55 TC at p 16; the same applies *a fortiori* in determining whether a property is a "home".

The fact that one does not have a room set aside for oneself in a "home" does not shed much light on whether it is a "home". The more important question is whether space is available when one wishes to use it. In Robert Frost's epigram, "home is the place where, when you have to go there, they have to take you in". This was the attitude taken by the Revenue in relation to the so-called "available accommodation rule" before 1993.

5.4.2 *"Permanent"*

The concept of "permanent" is more difficult than the concept of "home". The OECD commentary is untrammelled by the restraint of precision:

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2 No. 168 CM 200 (1987), at para 4.20

> 11 The Article gives preference to the Contracting State in which the individual has a permanent home available to him. This criterion will frequently be sufficient to solve the conflict, eg where the individual has a permanent home in one Contracting State and has only made a stay of some length in the other Contracting State.
> 12 Subparagraph (a) means, therefore, that in the application of the Convention (that is, where there is a conflict between the laws of the two States) it is considered that the residence is that place where the individual owns or possesses a home; this home must be permanent, that is to say, the individual must have arranged and retained it for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration.
> 13. ... But the permanence of the home is essential; this means that the individual has arranged to have the dwelling available to him at all times continuously, and not occasionally for the purpose of a stay which, owing to the reasons for it, is necessarily of short duration (travel for pleasure, business travel, educational travel, attending a course at a school, etc).

Para 11 of the commentary looks at the situation where "the individual has a permanent home in one Contracting State and has only made a stay of some length in the other Contracting State". The commentary is not making a contrast between:

(1) permanent, and
(2) a stay of some length.

The point correctly being made is that the existence of one (undoubtedly) permanent home impacts on whether one regards *another* place as a permanent home.

Paras 12 and 13 contrast:

(1) permanent use, and
(2) a stay of short duration; exemplified as "travel for pleasure, business travel, educational travel, attending a course at a school, etc".

This suggests that a stay of more than short duration qualifies as permanent.

5.5 Centre of vital interests

Article 4(2)(a) OECD Model Convention provides:

> if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);

The OECD commentary provides:

> 15 If the individual has a permanent home in both Contracting States, it is necessary to look at the facts in order to ascertain with which of the two States his personal and economic relations are closer. Thus, regard will be had to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. The circumstances must be examined as a whole, but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention. If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his centre of vital interests in the first State.

This is only relevant where the tie-breaker is not decided by the question of a permanent home.

5.6 Habitual abode

Article 4(3) OECD Model Convention provides:

> b) if
> [i] the State in which he has his centre of vital interests cannot be determined, or
> [ii] if he has not a permanent home available to him in either State,
> he shall be deemed to be a resident only of the State in which he has an habitual abode;

The OECD commentary provides:

16 Subparagraph (b) establishes a secondary criterion for two quite distinct and different situations:

(a) the case where the individual has a permanent home available to him in both Contracting States and it is not possible to determine in which one he has his centre of vital interests;

(b) the case where the individual has a permanent home available to him in neither Contracting State.

Preference is given to the Contracting State where the individual has an habitual abode.

17 In the first situation, the case where the individual has a permanent home available to him in both States, the fact of having an habitual abode in one State rather than in the other appears therefore as the circumstance which, in case of doubt as to where the individual has his centre of vital interests, tips the balance towards the State where he stays more frequently. For this purpose regard must be had to stays made by the individual not only at the permanent home in the State in question but also at any other place in the same State.

18 The second situation is the case of an individual who has a permanent home available to him in neither Contracting State, as for example, a person going from one hotel to another. In this case also all stays made in a State must be considered without it being necessary to ascertain the reasons for them.

19 In stipulating that in the two situations which it contemplates preference is given to the Contracting State where the individual has an habitual abode, subparagraph (b) does not specify over what length of time the comparison must be made. The comparison must cover a sufficient length of time for it to be possible to determine whether the residence in each of the two States is habitual and to determine also the intervals at which the stays take place.

5.7 Nationality and mutual agreement procedure

Article 4(2)(c)(d) OECD Model Convention provides:

c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;

d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

5.8 Trusts

INT Manual provides:

> **162034. Certificates of Residence and trusts and charitable trusts** [October 2007]
> Trusts are not themselves liable to tax in the UK, but the trustees on behalf of the trust may be liable to tax in the UK. A trust therefore cannot be a resident of the UK for the purposes of any UK Double Taxation Convention (DTC). Accordingly a certificate of residence cannot be issued in respect of any trust. However, some trusts are included within the definition of 'resident of a Contracting State' in specific DTCs. In those limited circumstances a certificate of residence can be issued in respect of a trust. It is therefore essential that the relevant DTC is checked on receipt of all applications.
> Trustees as a body (rather than the trust) are regarded as a single person. Where the trustees as a body are regarded as resident in the UK they will be entitled to the benefits of a DTC as they are liable to tax in the UK in respect of the income of the trust. Subject to the comments in the next paragraph a certificate of residence can be issued in respect of a UK resident body of trustees.

While it is no doubt correct that the taxable person is the trustee and not the trust, it does not make much if any difference which it is.

5.9 Partnerships

INT Manual provides:

> **162033. Certificates of Residence and partnerships** [October 2007]
> UK partnerships (including Scottish partnerships and UK LLPs) cannot be resident in the UK for the purposes of any of the UK's Double Taxation Conventions (DTCs) because they are not themselves liable to tax in the UK. Therefore they cannot claim the benefits of any DTC. However, UK resident partners are entitled to such benefits as they are taxed in the UK on their share of the partnership worldwide profits.

This is correct for OECD Model treaty-residence. Para 5 of the OECD Commentary to article 1 similarly provides:

> Where... a partnership is treated as fiscally transparent in a State, the partnership is not "liable to tax" in that State within the meaning of paragraph 1 of Article 4, and so cannot be a resident thereof for the purposes of the Convention.

However not all DTTs follow that model.

5.10 Tie-breaker for trusts and companies

Article 4.3 OECD Model Convention provides:

> Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated

The OECD commentary provides:

> 24. ... The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.

See "The Definition of Company Residence in Early UK Tax Treaties"; John Avery Jones [2008] BTR 556.

CHAPTER SIX

YEAR OF ARRIVAL AND DEPARTURE

6.1 Arrival and departure – Introduction

This chapter is concerned with income and gains accruing in a year during which an individual or a trustee becomes or ceases to be UK resident. It is necessary to consider income tax and CGT separately. For exit taxes on emigration see 7.1 (Exit taxes). The treatment of companies becoming or ceasing to be UK resident is not discussed.

6.2 Income tax on individuals

ESC A11 (Residence in the UK: year of commencement or cessation of residence) provides:

> [1] The Income and Corporation Taxes Acts make no provision for splitting a tax year in relation to residence and an individual who is resident in the UK for any year of assessment is chargeable on the basis that he is resident for the whole year.[1]

This is in principle correct.[2] However it is subject to two exceptions of

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1 Likewise HMRC 6 para 2.4 provides:

> "Strictly, you are taxed as a UK resident for the **whole** of a tax year if you are resident here for any part of it. But, if you leave or come to the UK part way through a tax year, the year may, by concession (Extra Statutory Concession A11), be split. This means that the UK tax you should pay because you are resident here is calculated on the basis of the period you are living here rather than for the whole of that tax year. This has the same effect as splitting the tax year into resident and not resident periods."

2 There is no case directly on the point, but there is indeed no provision splitting a tax year into periods of arrival and departure and it is difficult to imply one (what about allowances?). This is supported by *Neubergh v IRC* 52 TC 79 (refusal to split year in context of charge on investment income in FA 1968).

such breadth that the general principle rarely applies:

(1) Relief is available by concession ESC A11.
(2) Relief may be available under Double Tax Treaties

6.3 Concession A11

The concession continues:

> [2] But where an individual—
> (a) comes to the UK to take up permanent residence or to stay for at least two years; or
> (b) ceases to reside in the UK if he has left for permanent residence abroad,
> liability to UK tax which is affected by residence is computed by reference to the period of his residence here during the year.
> [3] It is a condition that the individual should satisfy the Board of Inland Revenue that
> [a] prior to his arrival he was, or
> [b] on his departure is,
> not ordinarily resident in the UK.

6.3.1 *Year of arrival*

The usual conditions for year of arrival treatment are therefore:

- The individual comes to the UK:
  (a) to take up permanent residence or
  (b) to stay for at least two years.
  ESC [2](a).

- Prior to arrival, the individual was not ordinarily resident: ESC [3][a].

The first limb of condition [2](a) is otiose since anyone who comes to take up permanent residence will fall within the second limb (he comes to stay for at least two years). In condition [2](a) I think the context shows that "stay for at least two years" must mean "be tax resident for two or more tax years". So an individual who is here from 1 September 2000 to 31 September 2001, who is therefore resident in 2000/01 and 2001/02, qualifies for year of arrival treatment in the year of arrival.

The individual who comes to the UK so as to be resident for only one tax year will not qualify for year of arrival treatment. This is bizarre because he may qualify for IT year of departure treatment and (I think) may qualify for CGT year of arrival treatment.

Condition [3][a] would only affect someone who (prior to arrival) is non-resident but ordinarily UK resident, which in practice never or hardly ever happens.

6.3.2 *Year of departure*

The usual conditions for year of departure treatment are:

- The individual must leave for permanent residence abroad: A11 [2](b).

- The individual must cease to be ordinarily resident in the UK: A11 [3][b].

Condition A11 [2](b) – permanent residence abroad – is stricter than the equivalent rule for the year of arrival, A11 [2](a). If "permanent" is read strictly, a person who leaves for a number of years, three years or even five years, does not qualify for year of departure treatment, unless the employment exception applies. But perhaps a reasonable length period abroad, say three years, is regarded as "permanent" for this purpose.

In respect of this condition, ESC A11 continues:

> The concession would not apply, for example, where an individual who had been ordinarily resident in the UK left for intended permanent residence abroad but returned to reside here before the end of the tax year following the tax year of departure.

Why? Does this assume that the individual is not ordinarily resident abroad in the year following the year of departure? I would have said that he was ordinarily resident, until he changed his mind and decided to return. It is however an unusual case, so the question will not often arise.

6.3.3 *Absence under contract of employment*

Condition [2](b) (to leave for permanent residence abroad) is relaxed in one case. ESC A11 provides:

> This concession is extended to the years of departure and return where, subject to certain conditions, an individual goes abroad for full time service under a contract of employment. These conditions are—
> – the individual's absence from the UK and the employment itself both extend over a period covering a complete tax year; and
> – any interim visits to the UK during the period do not amount to—
> (i) 183 days or more in any tax year; or
> (ii) an average of 91 days or more in a tax year (the average is taken over the period of absence up to a maximum of four years).

This is mainly relevant to year of departure treatment for an employee who leaves the UK but not for *permanent* residence abroad so he does not meet condition A11 [2](b). It could also apply to year of arrival treatment, for an employee who returns to the UK but only to stay for one year, so he does not meet condition [2](a). One could just imagine cases where an individual qualifies for year of arrival treatment under this paragraph, but normally if an individual leaves under a contract of employment for a year he ceases to be ordinarily resident and will qualify under the usual conditions.

6.4 IT computation where ESC A11 applies

ESC A11 simply states:

> liability to UK tax which is affected by residence is computed by reference to the period of his residence here during the year.

There are several possible ways of computing liability by reference to the period of residence. One is time apportionment by reference to the length of the resident and non-resident periods. Another is to identify the income arising in the period of residence.

6.4.1 *What is the period of residence?*

ESC A11 refers to "the period of residence here during the year" and the first step is to ascertain this period.[3]

From 2008/09, days of arrival are counted, but days of departure are not: one applies the usual rule that a day only counts if one is present at the end of the day.

There is no other guidance on how to ascertain the period of residence here. Here is just a selection of cases:

	Days present: case 1	**case 2**	**case 3**
April (from 6th)	0	1	7
May	0	0	0
June	0	0	2
July-April	continually present	continually present	continually present

In case 1 the individual's period of residence begins 1 July. Is case 2 different because of the one day visit in April? It is thought not, for one would not describe the individual as resident here in the period April–June if he was only here for one day. It should be the same even if at the time of the day's visit in April the individual had already decided to stay from July to the following April. If that is right then even in case 3, the individual's period of residence starts in July. But where the dividing line comes is hard to say. What if he is resident in all of April, then away, and continuously present from October. Is he resident in the period April–October? Or only from the beginning of October? It is suggested that it depends on intention. If during the April visit he did not intend to come in October, he is not resident during that period. In practice no doubt we muddle through.

6.4.2 *Habitual visitors*

The Inspectors Manual provided at 1664:

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3 ESC A11 also refers to "arrival" and "departure" and clearly the period of residence is between those two.

> **Visitors resident from 6 April**
> An individual who, by reason of habitual and substantial visits, becomes chargeable as a resident for and from the fifth year of such visits (see (a)(ii) of IM45)[4] should be treated as resident for the whole of the year for the purpose of this guidance.

The reason is presumably that in the case of a person making sporadic visits, there is often no obvious way of identifying the period of residence.

6.5 Computation in year of arrival – RFI

6.5.1 *RFI: arising basis*

IR20 (withdrawn from 2009/10) was difficult to follow by the time it reached its 2008 version, because parts of it were out of date, discussing the preceding year basis (abolished 1996/7) and paying and collecting agents rules (abolished in 2000). The 2008 updates to IR20 made no attempt to address this problem. But apart from some curious rules relating to source ceasing (which were anomalous before 2008 and one can assume have no relevance now) IR20 opted for time apportionment. The Inspectors Manual para 1663 (also withdrawn) provided an example which conveniently illustrated this approach:

> ***New arrivals on or after 6 April 1997***
> *Where an individual arrives in the UK on or after 6 April 1997 and is regarded as resident from the date of arrival, his liability in respect of overseas income within Cases IV or V should be determined as follows.*
> *(1) No liability arises where the source of income ceases before permanent residence begins.*
> *(2) Liability for the year of arrival should be based*
> *(a) where the arising basis applies, upon the proportion on a time basis from the date of arrival to the following 5 April, of the full amount of income arising in the year of arrival.*

The Manual then gave an example which helpfully illustrated the rule:

> *For example, an individual arrives in the UK on 6 October 1997 and is regarded as UK-resident from that date. Case V income arose as*

4 This passage in the Inspectors Manual set out the short term visitors rates.

follows:–

30/6/97	*£100*
30/9/97	*£200*
31/12/97	*£150*
31/3/98	*£250*
[total	*£700]*

If the arising basis applies, the amount chargeable for 1997–98 will be 6/12 x £700 =£350

I describe this as "**time apportionment**".

However, HMRC 6 provides:

> **10.14.1 When you become resident in the UK**
> When you come to the UK during a tax year and are resident from the date of your arrival, you are liable to UK tax on your UK investment income for the whole of the tax year, subject to the terms of any DTA which might apply to you.
> You will not be liable to UK tax on foreign investment income *arising before the date of your arrival* under extra statutory concession A11.

This suggests that HMRC may have altered their practice, and one now should identify when the income arose and income attributable to the pre-arrival period is not taxed. This is consistent with the approach adopted for departure.

Of course one would have expected a major change of practice of that kind to be discussed in advance, and highlighted, and possibly HMRC may continue to accept time apportionment, at least when it gives roughly the same result as identifying the actual income of the resident and non-resident periods.

6.5.2 *RFI: remittance basis*

The terms of the ESC require that tax is "computed by reference to the period of residence here during the year" which suggests that where the remittance basis applies:

(1) income arising prior to that period of residence, time apportioned, should be disregarded; and
(2) remittances made prior to that period of residence, should be disregarded.

HMRC accept this view. Q14 January 2009 Qs & As provides:

> **Q14:** A Polish plumber comes to the UK in September 2008, having worked until August 2008 in Poland. He will be caught by 809D as ESC A11 does not apply but will not be caught by 809X as ESC A11 does apply. It appears anomalous that the April to August income can be treated as unremitted and potentially taxable income for one purpose and then not taxed when remitted for another purpose.
> **A:** The disregard of split year treatment applies solely for the purposes of determining whether an individual will need to claim the remittance basis under s809B ITA or whether they can rely upon s809D to use the remittance basis without making a claim because their total foreign income and gains are below the £2,000 threshold (and thereby retain their personal allowances and AEA). ESC A11 continues to apply in terms of what income is chargeable to tax.
> Remittances of foreign income arising in the months before an individual came to the UK (assuming the individual was not temporarily non-resident) will not be taxable under the terms of the A11 concession.

6.6 IT Computation in year of departure

6.6.1 *RFI: arising basis*

The method of computation for the year of departure was formerly entirely different, and more generous, than for the year of arrival. IR20 (withdrawn from 2009/10) provided:

> *Investment income of those who leave, or come to, the UK part way through a tax year*
> ***Leaving the UK***
> *6.15 For tax years up to the year ending 5 April 2008, for overseas investment income where you are **not** taxed on the remittance basis, you will pay tax on the smaller of*
> *[a] the actual overseas investment income arising for the period from 6 April to the date of your departure, and*
> *[b] the same fraction of your total overseas income for the year of departure as the fraction of the full tax year for which you are resident in this country. For example, if you are resident in the UK from 6 April until 6 October in the same tax year, i.e. 6 months, the fraction is 6/12.*
> *For tax years from 6 April 2008 onwards, the same rules will apply,*

depending on your personal circumstances. If you have chosen not to claim the remittance basis in the tax year of your departure you will be liable to pay UK tax on all of your income, including your overseas investment income, up to your departure from the UK – see paragraph 5.12.

However the practice seems to have been quietly changed. HMRC 6 now provides:

> **10.14.2 When you stop being resident in the UK**
> When you leave the UK during a tax year and become non-resident here on the day after your departure, you will be liable to UK tax on your UK investment income for the whole of the year. In the tax year of your departure, you will not be liable to UK tax on your foreign investment income following the date of your departure under extra statutory concession A11. Up to the date of your departure from the UK you will be liable to UK tax on your foreign investment income, subject to whether you use the remittance basis in the tax year of your departure.
> **10.14.3 When you do not use the remittance basis**
> If you do not use the remittance basis in the year of departure you will be liable to UK tax on your foreign investment income which arose when you were resident in the UK under extra statutory concession A11.

6.6.2 *RFI: remittance basis*

IR20 (withdrawn from 2009/10) provided:

> *6.16 For overseas investment income where you are taxed on the* ***remittance basis*** *(see para 6.2), you will pay tax on the smaller of*
> *[a] the actual overseas investment income remitted to the UK in the period from 6 April to the date of your departure, and*
> *[b] the same fraction of the total overseas income you remit to the UK in the year of departure as the fraction of the full tax year for which you are resident in this country.*[5]

5 Similarly, the Inspectors Manual provided:
1667. Persons ceasing to be resident in UK
Where a person (other than an individual of the type referred to in IM45 [See 6.4.2 (Habitual visitors)]) takes up permanent residence abroad and ceases to be resident in this country, any liability under Case IV or V for the year in which residence here ceases should be based on—

However the practice seems to have been quietly changed. HMRC 6 now provides:

> **10.14.4 When you use the remittance basis**
> If you use the remittance basis in the year of departure you will be liable to UK tax on your foreign investment income which you remitted to the UK before you departed under extra statutory concession A11.

6.7 Employment income

6.7.1 *Application of ESC A11 to employment income*

EIM para 42860 provides:

> **Residence or employment in the UK: "split year" treatment**
> Employees resident and not resident in the UK in the same tax year
> Where the employee is treated as resident and not resident for different periods of the same tax year:
> - the instructions at EIM40101 onwards apply as though the resident and not resident parts of the year were separate tax years and
> - the results for each part should then be added together to obtain the total liability for the tax year.
>
> But see EIM33052 as regards terminal leave pay.

6.7.2 *Pre-commencement and post-cessation earnings*

The rule for pre-commencement and post-cessation earnings are set out in s.17 ITEPA:

> 17 Treatment of earnings for year in which employment not held
> (1) This section applies for the purposes of this Chapter in a case where general earnings from an employment would otherwise fall to be regarded as general earnings for a tax year in which the employee

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(a) the proportion, appropriate to the period from 6 April to the date of departure, of the income arising or remitted, as the case may be, in the ... year of departure ...
or
(b) the actual amount of the income arising or remitted, as the case may be, in the period from 6 April to the date of departure,
whichever is the less.

does not hold the employment.

(2) If that year falls before the first tax year in which the employment is held, the earnings are to be treated as general earnings for that first tax year.

(3) If that year falls after the last tax year in which the employment was held, the earnings are to be treated as general earnings for that last tax year.

(4) This section does not apply in connection with determining the year for which amounts are to be treated as earnings under Chapters 2 to 11 of Part 3 (the benefits code).

EIM 40006 and 40007 provide:

Effect of non-residence on pre-commencement and post-cessation earnings

Where the special rules in EIM40005 apply general earnings will be taxable when received if the charging provisions in Sections 15, 21, 25 or 27 apply in the last or first year the taxpayer held the job. The same is true if the taxpayer left the job at the time of going abroad.

Extra-Statutory Concession A11 (ESC A11) (see EIM42850), which provides split year treatment, cannot be used to take out of charge earnings which in substance relate to service in the UK. The same principle applies where the taxpayer takes up a new job on becoming resident in the UK.

In some cases however the taxpayer may leave the job after ceasing to be resident in the UK. Equally the job might start before the taxpayer arrives in this country. In these circumstances it may be reasonable to split the post-cessation or pre-commencement payment between the part of the year when the taxpayer falls within the relevant charging provision and the rest of the year. But this split should not necessarily be made on a time basis. For example, the post-cessation receipt may be primarily attributable to the taxpayer's service in the UK. If it is, a split that reflects the facts should be agreed.

If the taxpayer is unable to agree, the alternative is that the earnings are taxable on the strict statutory basis, that is, without the benefit of ESC A11. The entire sum will be taxable under Section 15 or 21 because the taxpayer is resident and ordinarily resident for the whole tax year.

See example EIM40007 for illustrations of Sections 17 and 30.

40007. Effect of non-residence on pre-commencement and post-cessation earnings: Examples

This page provides examples of how the above sections apply. ...

The first example concerns pre-commencement earnings of an employee who is resident, ordinarily resident and domiciled throughout:

> An employee is approached by another employer. She is offered a job by the new organisation. As an inducement to change jobs she is paid £50,000 on 1 April 2004. She commenced work for the new employer on 1 May 2004. The employee is resident, ordinarily resident and domiciled in the UK so the relevant charging provision is Section 15 in Part 2 Chapter 4 ITEPA.
> Section 17 ITEPA operates to make the payment earnings of the year in which the employment commences. Even though paid in tax year 2003/2004 they are earnings "for" the year 2004/05.

This is correct. The Manual then considers whether domicile makes any difference:

> **Example 1**
> The result will be the same if the relevant charging provision is Section 21 ITEPA because the employee is resident, ordinarily resident but not domiciled in the UK. However, Section 30 ITEPA operates rather than Section 17 as the charging provision is in Part 2 Chapter 5.

This is correct. It is assumed that s.21 ITEPA applies, i.e. that the earnings are not chargeable overseas earnings.[6] The Manual now considers someone coming to the UK:

> **Example 2**
> An employee worked in Singapore for many years for a UK resident company. The employment ceased on 31 December 2003. For 10 years prior to that date the individual was not resident and not ordinarily resident although domiciled in the UK. On 6 April 2004 the employee returned to the UK. From the date of arrival he became resident and ordinarily resident.
> 6 months after the job ended [30 June 2004] the employer made a payment of £50,000 to the former employee in recognition of the contribution he had made to the expansion of business in the Far East. Section 17 ITEPA makes the payment earnings of the year in which the

6 See 12.2 (Resident, ordinarily resident and foreign domiciled employee).

employment was last held, 2003/2004. In that year the employee was not resident in the UK and performed all of the duties in Singapore. In consequence, the payment does not fall into any of the charging provisions in Part 2 Chapters 4 and 5 and is therefore not chargeable to tax as general earnings.

6.7.3 *Employment-related securities*

The Employment-Related Securities Manual provides:

> **70460. Date of departure from UK and ESC A11** [May 2007]
> Section 421E(2) ITEPA 2003 should be read in relation to the whole of the final year of residence in the UK without regard to Extra-Statutory Concession A11.
> This means that where an employee, who is resident but not ordinarily resident in UK when granted a securities option, exercises the option after leaving the UK the gain on exercise would remain taxable under Chapter 3C even if realised in the part of the tax year falling after departure.

6.8 Interest from FOTRA securities

IR20 (withdrawn from 2009/10) para 6.6 provided:

> *UK tax is not chargeable on interest arising on* ***UK Government 'FOTRA' securities****, if you are not ordinarily resident in the UK. 'FOTRA' stands for 'Free of Tax to Residents Abroad'. Where we treat you as becoming, or ceasing to be, ordinarily resident in the UK part way through the tax year, no tax will normally be charged on interest payable while you are not ordinarily resident—that is, before the date you arrive here or after the date you leave.*

There are two possible justifications for this.

(1) The rule that one must be resident for the whole of a year and not for part of a year does not apply to ordinary residence.
(2) ESC A11 applies.

It is considered that the first reason is the correct one.[7] So the rule is statutory, not a concession and it always applies (not just "normally"). HMRC 6 contains no guidance on the point, but there is no reason to think that HMRC practice has changed.

6.9 Income within s.624 ITTOIA

The Manuals do not deal with this expressly, but ESC A11 is in general terms, so it must be assumed that the RFI rules set out above apply.

6.10 Income within s.720 and s.731 ITA

It is considered that one can split years by reference to the periods of ordinary residence.[8]

6.11 Non-residents income tax relief

ESC A11 provides:

> Where the concession applies and the tax year is split, FA 1995 s 128 [now s.811 ITA] (limit on income chargeable on non-residents—income tax) does not apply for the period for which an individual is treated as not resident. That section only applies to complete years of non-residence.

For a discussion of the relief, see 31.1 (Non-residents IT relief). There is no good reason for this anomaly, but there it is.

6.12 Gains from life policies, etc.

ESC A11 does not apply to chargeable event gains.[9] There is some sense in this, because policies already qualify for non-resident period relief.[10]

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7 See 3.2.3 (Ordinary residence during part of tax year).

8 See 3.2.3 (Ordinary residence during part of tax year).

9 See 22.4.2 (Individual non-resident in year of chargeable event).

10 See 22.4.3 (Non-resident period relief).

6.13 Accrued income scheme

HMRC 6 provides:

> If you hold securities with a nominal value of more than £5,000 during a tax year in which you are resident in the UK at any time, special tax provisions (the 'accrued income scheme') will apply when the securities are transferred. You will be charged UK income tax on the interest that has built up ('accrued') over the period you owned the securities following the last interest payment, even if you were not resident in the UK for part of that period.

In principle this is of course right, but it is not (I think) addressing the position in the year or arrival or departure. It is suggested that ESC A11 applies.

6.14 Withholding tax on interest

Once the individual becomes non-ordinarily resident he is entitled to receive interest from UK deposit-takers free of withholding tax.[11] The relevant form must be completed. In this context, note that the TDSI Guidance Notes (February 2009) provide:

> **4.52 Emigration**
> Strictly, a declaration made in contemplation of, but before, leaving the UK is not acceptable. But Financial Institutions may accept such declarations provided they satisfy themselves, before paying interest without deduction of BRT, that the investor has left the UK. A note of any enquires made should be kept in the investor's records.

6.15 Income tax on trustees

If a trust changes residence the HMRC view is that the tax year is split into UK and non-UK resident periods. HMRC Residency: Non-resident Trusts (published 1 April 2008) provides:

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11 See 29.7 (Withholding tax on interest from deposit-takers).

> **Change in residence status of body of trustees**
> A change in the residence status of a body of trustees is usually caused by a change in the trustees who make up the body. It can also happen where the trustees remain the same but one of them changes their residence status.
> For income tax purposes if the residence status of a body of trustees changes during the tax year then the trustees are potentially liable for income tax on all their worldwide income for the period they were actually resident. They are only liable for income tax on their UK source income for the period they were actually non-resident.[12]

HMRC do not argue that the introduction of the rule that trustees are a separate person for IT has altered the position.

6.16 CGT on individuals

Section 2(1) TCGA provides:

> ... a person shall be chargeable to capital gains tax in respect of chargeable gains accruing to him in a year of assessment during any part of which he is resident in the UK, or during which he is ordinarily resident in the UK.

CGT is charged on gains of a year *during any part of which* the individual is UK resident. If a UK resident individual leaves the UK to take up residence abroad, he is strictly subject to CGT on gains accruing until the following 6 April; if, while non-resident, he disposes of an asset, he is strictly subject to CGT if he becomes UK resident before the following 6 April.

As with income tax, this is subject to two exceptions of such breadth that the general principle rarely applies:

(1) Relief is available by concession: ESC D2.
(2) Double Tax Treaties split UK tax years into resident and non-resident periods.

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12 See *www.hmrc.gov.uk/cnr/nr_trusts.htm*. The statement in ESC A11 [1] that years are not split refers to an individual: see 6.2 (Income tax on individuals)

6.16.1 *Section 13 TCGA*

Section 13 TCGA is an exception: the charge only applies if the individual is resident at the time the gain arises, so it is not necessary to rely on ESC D2.

6.17 **Concession D2**

ESC D2 provides:

> 1. [a] An individual who
> [i] comes to live in the UK and
> [ii] is treated as resident here for any year of assessment from the date of arrival
> is charged to capital gains tax only in respect of chargeable gains from disposals made after arrival,
> [b] provided that the individual has not been resident or ordinarily resident in the UK at any time during the five years of assessment immediately preceding the year of assessment in which he or she arrived in the UK.
>
> 2. [a] An individual who
> [i] leaves the UK and
> [ii] is treated on departure as not resident and not ordinarily resident here
> is not charged to capital gains tax on gains from disposals made after the date of departure,
> [b] provided that the individual was not resident and not ordinarily resident in the UK for the whole of at least four out of the seven years of assessment immediately preceding the year of assessment in which he or she left the UK.[13]

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13 The concession continues:

> "3. This concession does not apply to any individual in relation to gains on the disposal of assets which are situated in the UK and which, at any time between the individual's departure from the UK and the end of the year of assessment, are either:
> (i) used in or for the purposes of a trade, profession or vocation carried on by that individual in the UK through a branch or agency; or
> (ii) used or held for, or acquired for the use by or for the purposes of such a branch or agency."

This is consistent with the usual CGT rule for trades carried on through a branch or agency.

6.17.1 *Year of arrival*

The conditions for year of arrival treatment are:

- the individual comes to live in the UK: D2 1[a][i]
- the individual is treated as resident here from the date of arrival: D2 1[a][ii]
- the individual has not been resident at any time during the 5 years of assessment before the year of arrival: D2 1[b]

Condition 1.[a][i] is not in fact a separate condition, since anyone who meets condition 1[a][ii] must come to live in the UK.

Condition 1[a][ii] is puzzling. If the concession applies the individual is treated as resident here from the date of arrival, if it does not, he is not, so that can hardly be a condition of the concession. Perhaps its point is to withhold the concession for habitual visitors who become UK resident in the fifth year of visits.[14]

Condition 1[b] was introduced as a consequence of the temporary non-residence rules in 1998. But the condition is stricter than the temporary non-residence rules.

It is necessary to ascertain the date of arrival and departure: see 6.4.1 (What is the period of residence?).

6.17.2 *Year of departure*

The conditions for year of departure treatment are:

- the individual leaves the UK: D2 2[a][i]
- the individual is treated on departure as not resident: D2 2[a][ii]
- the individual was not UK resident for at least 4 out of 7 of the years of assessment before the year of departure: D2 2[b].

Once again, condition 2[a][i] is otiose, but it does not matter. Condition 2[b] was introduced as a consequence of the temporary non-residence

14 See 6.4.2 (Habitual visitors).

rules in 1998. But the condition is stricter than the temporary non-residence rules. Where the taxpayer has been resident or ordinarily resident in 4 out of the 7 preceding years then gains from disposals made in the year of departure, after the date of departure, are chargeable to CGT whether or not the taxpayer ever returns to the UK to become resident again.

There is an extended time limit for assessments for individuals leaving the UK if they return within five years.[15]

6.18 Computation of CGT

ESC D2 operates differently from A11. One does not compute the total gains of the year and time apportion. D2 states that one ignores disposals in the non-resident part of the year.

Under the remittance basis, gains are treated as accruing when remitted.[16] It is suggested that this does not change the date of disposal for the purposes of the remittance basis, or else a foreign domiciliary who remits gains pays more CGT than a UK domiciled individual.

6.18.1 *Losses*

The concession says nothing about allowable losses accruing in the non-resident part of the year. The possibilities are:

(1) losses of the period remain allowable although gains of the same period are not;
(2) losses of the period are allowable only so far as they exceed the gains of the same period;
(3) Losses of the period are not allowable at all.

Solution (1) is too good to be fair, but it is the most consistent with the words of the concession and it is tentatively considered that this is correct. Solution (3) is the most sensible, but cannot be applied, since it imposes more tax than would be the case without the concession. If the concession were made statutory (as it ought to be) this problem would not arise.

15 See 8.10.4 (Time limit for assessment).
16 See 36.2.1 (Date of disposal under remittance basis).

6.19 CGT on trusts – year of arrival and departure

ESC D2 provides:

> 4. This concession does not apply to
> [a] the trustees of a settlement who commence or cease residence in the UK[17] or
> [b] to a settlor of a settlement in relation to gains in respect of which the settlor is chargeable under [TCGA sections 77–79, or][18] TCGA section 86 and Sch 5.

The CGT concession does not apply to trustees or to a settlor who is chargeable on the gains of a non-resident settlement. This is an anomaly, but a necessary one, because if by concession the trustees or settlor were not charged to tax in a split year, the untaxed gains would not be s.2(2) amounts (trust gains), and so may escape tax altogether. Though if the concession was made statutory as it ought to be, this anomaly could easily be corrected.

6.20 CGT planning – postponing disposals until non-resident

The obvious CGT planning is to postpone disposals until non-resident. The CG Manual discussion is mostly pedestrian and partly out of date; but the practitioner needs to read it to see how HMRC approach the issues:

> **25800. Attempted avoidance on emigration**
> When an individual plans to emigrate from the UK, he or she will often want to dispose of their assets located in the UK before departure. This is particularly true of privately run businesses carried on in the UK but it is often also true of other property located in the UK. For such assets it may be necessary, or at least convenient, for the individual to be in the UK to deal with negotiations for the sale. The individual may also need to have a definite sale arranged in order to

17 The same point is made in SP 5/92 para 2:

> Under TCGA 1992 s 69, a body of trustees is regarded as capable of changing its residence status part-way through a year of assessment. It must be borne in mind, however, that TCGA 1992 s 2(1) provides that the trustees are liable to tax on all chargeable gains of a tax year during any part of which they are resident or during which they are ordinarily resident in the UK.

18 The reference to s.77-79 TCGA is not applicable from 2008/09 as these sections have been repealed.

ensure he or she has funds for use in the country to which he or she is emigrating.
25801. Arrival in/departure from UK
The emigrating individual will have an expectation that he or she will be treated as not resident and not ordinarily resident from the date of departure.
If the disposal occurs before the date of departure the individual will be liable to a charge to UK Capital Gains Tax in respect of the chargeable assets disposed of.
[omitted text accidentally repeats para 25802]
25802.
If the disposal occurs after the date of departure but before the following 6 April there will be no charge to CGT if ESC D2 is applied, see CG25760. And if the disposal occurs after 5 April following departure the gain will be exempt because when it occurs it is outside the scope of TCGA 1992, S 2.
Thus if the sale is genuinely postponed until after the date of departure there will be no charge to UK Capital Gains Tax.
25803.
Finance Act 1998 introduced a new TCGA 1992, S 10A, see CG26100+, which charges Capital Gains Tax on certain gains accruing to former UK residents during a period of temporary non-residence abroad, defined as a period of less than five full tax years. ESC D2 was revised, see CG25762, to bring its terms broadly into line with the provisions of Section 10A.
Consequently, for departures on or after 17 March 1998, gains on disposals after the date of departure, which previously might not have been charged to Capital Gains Tax, may now be chargeable under TCGA, 1992, S 2 TCGA 1992, S 10A. However, there will still be cases where such gains will not be chargeable to Capital Gains Tax, for example where the individual remains non-resident for more than five tax years, and the following guidance will still be relevant in those cases.
25804.
In a small number of cases the transactions described in CG25800 may be carried out in such a way that will

- enable the individual to have certainty or near certainty by the date of emigration that the sale will occur but
- make it appear that the disposal takes place after that date.

In suitable cases you should consider whether there is liability to Capital Gains Tax using the following guidance.

The CG Manual then sets out three ways to attack this planning:

25805. Arrival in/departure from UK
There are three circumstances in which Capital Gains Tax liability may arise where the date of disposal appears to be after the date of emigration. These are where it can be shown that
1) there was a binding agreement or contract for sale on or before the date of emigration or
2) a business was carried on in the UK through a branch or agency in the period from the date of emigration to the date of disposal or

3) an attempt has been made to use ESC D2 for tax avoidance.

Detailed guidance on each of these is contained in the following paragraphs.

25820.

When an individual claims that a disposal is exempt because it is made at a time when he is not resident and not ordinarily resident you should firstly establish the facts concerning two basic points

- what is the date of disposal in a written contract and
- what is the individual's residence status on that date?

25830.

In the case of a disposal under an unconditional contract the date of disposal is the date the contract is entered into not the date of completion (TCGA 1992, S 28 (1)). However, it is not unknown for taxpayers and/or their agents to quote the date of completion as the disposal date.

Oh dear.

It can therefore be worth checking that the date quoted is not in fact the completion date. Once you are satisfied on this point the next step is to establish whether, and if so, on what date the individual became not resident and not ordinarily resident.

25831. Establishing the basic facts [June 2003]

You should obtain a residence ruling from Centre for Non-Residents, CNR1 before proceeding further with the case. You should follow the procedure laid down in IM32 in doing this.

6.20.1 *Binding agreement before departure?*

The CG Manual turns to the first of the three lines of attack:

25850. Delayed written contracts

The most common situation is for the individual to negotiate the terms for a disposal but to delay signing the written contract until after the date of departure from the UK. One indicator that this may have happened will be if there is a very short interval between the date of departure and the date the contract is signed.

25851.

Cases have been seen where the vendor leaves the UK with a copy of the contract in his possession and posts it from the foreign airport on arrival there. Alternatively, he gives his solicitor a power of attorney under which the solicitor can sign and exchange the contracts on behalf of the vendor once he is outside the UK. There are many other variations.

The author's indignation is misplaced and somewhat naive.

25852. Binding contract pre-dating emigration

In most straightforward cases, where there is no question of a continuing business or where arrangements have not been entered into to use ESC/D2 to avoid tax, it will not be possible to show there is liability to Capital Gains Tax. An agreement, oral or written, which remains 'subject to contract' is not a binding contract.

Where a formal written contract is entered into after emigration, there is a presumption that the parties intend to leave the transfer unagreed until that time even if it is not specifically 'subject to contract'.

25853.

It will not be possible to take any action if

- the asset involved is an interest in land situated in England or Wales and
- it was disposed of after 27 September 1989 and
- it was not disposed of until after 5 April following departure from the UK and
- no charge is possible under TCGA 1992, S 10 or TCGA 1992, S 25 as a result of the asset being used in or for the purposes of a trade, profession or vocation carried on in the UK through a branch or agency or it being used or held for the purposes of such a branch or agency.

25854.

This is because of legislation enacted with effect from 27 September 1989 requiring all disposals of interests in land in England and Wales to be evidenced in writing if there is to be a valid contract, see CG14263. For disposals after that date an oral contract will not be a valid contract. When this fact is coupled with the fact that our only counter where the written contract is delayed until after 5 April is to establish the existence of a binding agreement preceding the date of sale, see CG25860 below, it becomes obvious that a challenge cannot succeed. In such circumstances it will not be appropriate to pursue the case further.

25855.

You should note that the above applies only when the land is situated in England and Wales. It does not apply if the land is situated in Scotland, Northern Ireland or any other country where the legislation does not require the contract to be in writing in order for it to be valid.

25860.

A disposal occurs at the earliest time at which there is a binding contract between the parties. Except where there is a statutory requirement for a contract to be in writing if it is to be valid (see CG25853 – CG25855 above), it does not matter whether the contract is oral or written. *Thompson v Salah* 47 TC 559 established that a binding oral contract can be just as effective as a written contract in giving rise to a disposal for Capital Gains Tax purposes.

25861.

Establishing the existence of a binding contract, oral or written, in advance of the formal contract presents considerable difficulty, see CG25852 above, and requires the facts of the case to be established in detail. Usually this will involve reviewing the correspondence, notes of meetings, telephone conversations, etc which have taken place between the vendor and purchaser (or more usually their professional representatives) prior to the date of signing the formal documents, to see whether there is evidence of a binding oral agreement or whether the correspondence itself gives rise to a binding written agreement. It will not usually be worthwhile to undertake such a detailed review unless there are strong

prima facie indications of a pre-emigration binding agreement.
25862.
If a binding agreement prior to the date of formal documentation can be established, the date of the earlier agreement is the date of disposal for Capital Gains Tax purposes.

6.20.2 *Branch/agency*

This is the second line of HMRC attack, though the circumstances in which it arises will be rare:

25900. Business through branch/agency
If an individual is carrying on a trade or profession (and possibly even if he or she is carrying on a vocation) in the UK prior to his or her emigration, that individual may find it necessary to sell the business as a going concern if the best price is to be realised. If the written contract for sale of the business assets is to be delayed until after departure, the individual will need to make arrangements for the business to continue operating in his or her absence. In most such cases we will be able to argue that in the period between departure and the date the contract is signed the activity has been carried on in the UK through a branch or agency.
25901. Business through branch/agency
In the above circumstances
· if the disposal occurs after the date of emigration but before the following 6 April the disposal will be within Section 2 TCGA 1992 and ESC D2 will not apply (see CG25770)
· if the disposal takes place after 5 April following the date of emigration TCGA 1992, S 10 will apply (see CG25520+).
In either case the individual will be within the charge to Capital Gains Tax...

6.20.3 *Withdrawal of concession*

This is the third line of HMRC attack:

25980. Withholding benefit of ESC D2 [October 2004]
A warning is published at the front of booklet IR1 – Extra Statutory Concessions. This reads as follows.
'The Concessions described within are of general application, but it must be borne in mind that in a particular case there may be special circumstances which will require to be taken into account in considering the application of the concession. A concession will not be given in any case where an attempt is made to use it for tax avoidance.'
This is sometimes referred to as the 'health warning'.
25981. Withholding benefit of ESC D2
If you are dealing with a disposal after the date of departure from the UK but

before the following 6 April, exemption from Capital Gains Tax arises only by reason of ESC D2. The 'health warning' is therefore of relevance to all such cases. Where it can be established that the taxpayer has entered into arrangements in an attempt to use the terms of ESC D2 to avoid liability to Capital Gains Tax which would otherwise arise the Board will consider withholding the benefit of ESC D2 under the terms of the 'health warning'.

The case of *R v HMIT ex p. Fulford-Dobson* (60 TC 168) is an example of a case where the benefit of the concession was withheld because of attempts to use it for avoidance purposes.

In this case:

(1) The taxpayer's wife (a UK resident) gave an asset to her husband who was just about to take up employment abroad.

(2) He sold the asset shortly after leaving the UK but before the following 6 April.

HMRC refused to apply the concession and an application for judicial review was unsuccessful.

25982. Withholding benefit of ESC D2

In straightforward cases where the contract of sale is delayed until after the date of emigration, see CG25850, the Board have decided that they will not withhold the concession merely on the grounds that the disposal was arranged to take place after the date of departure from the UK. On its own, a genuine postponement of the disposal is not regarded as an attempt to use the concession for tax avoidance, but where coupled with other arrangements it might be so regarded.

Note that here, as throughout the passage, "genuine" is used as the opposite of "tax avoidance."[19] The CG Manual continues:

25983. Withholding benefit of ESC D2

Where the facts support the withholding of the concession and there is also an argument about the existence of a pre-emigration agreement which could be arbitrated by a hearing before Commissioners (see CG25880 above), the Board will normally wish to withhold the benefit of the concession as its primary action.

25984.

In all cases where you think the Board may wish to consider withholding the benefit of ESC/D2 you should obtain the full facts. Usually this will involve reviewing the primary documents including correspondence, notes of meetings, telephone conversations, etc which have taken place between the vendor and purchaser (or more usually their professional representatives) prior to the date of signing the formal documents.

25985.

If you are asked to explain the reasons for your enquiries you may point out to

19 See 21.17.3 ("Genuine").

the taxpayer the existence of the 'health warning' and you may say that it is necessary to establish the facts to enable a decision to be made about whether or not the case falls into that category.

25986. Withholding benefit of ESC D2 [March 2007]

However, if you conclude that your case is one where the benefit of ESC/D2 should be withheld you MUST submit your papers to Capital Gains Technical Group before any mention of this is made to the taxpayer.

26010. Other devices [March 2007]

Individuals may make use of a number of devices to cause at least part of the gain to apparently arise after the date of departure. Some of the possibilities are listed in CG26020 – CG26061 below. It may be possible to counter some of the devices by withholding the benefit of ESC/D2. Capital Gains Technical Group will be pleased to advise on any of these types of case but they must be submitted *before* any suggestion is made that the concession might be withheld.

26020. Splitting a single contract

In this type of case, what would normally have been included in a single contract for sale is split into two contracts. For example, a farmer owning a farmhouse and associated farmland emigrates; he claims to have sold the farmhouse *prior* to departure (possibly to give immediate access to capital) and the farmland *after* the date of departure, and points to the fact that two separate contracts have been entered into. Relief under TCGA 1992, S 222 is claimed on the disposal of the farmhouse. In such cases, it may be possible to sustain an argument that, in reality, there is only a single disposal for capital gains purposes, the date of disposal of the farmland and the farmhouse being the same: that is to say, the earlier of the two dates.

26030. Conditional contracts

Cases have been seen where it is claimed that the date of disposal for capital gains purposes does not occur until the satisfaction of a condition written into the terms of the agreement for sale. To decide whether a condition is such as to make a contract conditional within the terms of TCGA 1992, S 28 (2) can be difficult. You will need to consider the full facts of the case in the context of contract law. The leading textbook on this subject is 'Chitty on Contracts'. This may be available in a local reference library.

26040. Options

Sometimes the owner, before emigrating, grants an option to a potential purchaser to buy the asset, that option to be exercised during a specified period following the owner's emigration. If there is genuine uncertainty in the vendor's mind at the time of emigration as to whether the grantee will exercise the option, there are no grounds for withholding the benefit of the concession. As with pure delay cases, however, there may be evidence to show that the option was a sham and that the vendor is assured of his sale before he leaves the UK.

26050. Cross-options

These are cases where the vendor and purchaser each grant an option to the other party to sell/buy the asset which is the subject of the agreements. Invariably in these cross-options cases, the options are granted before the vendor leaves the UK, but one of the options is exercised (usually by the purchaser) after the vendor's date of departure. The Board will consider withholding the Concession

> if there appears to be no commercial reason for the issue of the cross-options.
> **26060. Transfer to spouse or to civil partner: Emigration** [March 2006]
> In this type of case, a husband or wife or a civil partner owns a valuable asset which he or she wishes to sell. The spouse or civil partner of the owner of the asset is leaving the UK – probably for a limited period such as a fixed term employment abroad. The owner transfers the asset to the departing spouse or civil partner prior to departure and claims the protection of Section 58 TCGA 1992. The asset is subsequently sold by the transferee after the date of departure. This tactic was adopted – unsuccessfully – in the case of *R v HMIT ex p. Fulford-Dobson* (60 TC 168).
> Cases of this type need to be distinguished from those where the transfer to the non-resident spouse or civil partner is made *after* that spouse or civil partner has become non-resident *and* in a year throughout the whole of which that spouse or civil partner is non-resident. In such cases the benefit of Section 58 can effectively be obtained as a result of the decision in *Gubay v Kington* (57 TC 601), see CG22300+.

Our Manual ends with a cliffhanger:

> **26061. Transfer to spouse: Emigration** [March 2006]
> Data to come.

6.21 CGT planning before arrival in the UK

The Manual discusses planning by emigration but gives no guidance to the converse situation where:

(1) a taxpayer arrives in the UK during a tax year;
(2) a disposal takes place before arrival (but in the same tax year so that ESC D2 is in point).

In order to take advantage of the concession, a taxpayer might arrange disposals just before arriving in the UK. He might do this in various ways:

(1) sell assets;
(2) enter into an unconditional contract with delayed completion;
(3) transfer assets to a trust or company, in which the taxpayer is interested.

Arrangement (1) above should not lose the concession (cf CG Manual 25982 cited above). But (2) possibly, and (3) clearly, take us into what

HMRC would regard as "devices" (i.e., avoidance) and should not be adopted unless there is a good non-tax reason.

A taxpayer might realise losses (which are in principle allowable) at the same time as realising gains which (under the concession) are not taxable. In these circumstances, HMRC might justifiably feel that the taxpayer is getting the best of both worlds and seek to withdraw the concession if they can identify any element of tax planning in the timing of disposals.

It is best, wherever possible, not to rely on the concession at all except in the simplest cases.

6.21.1 *Appeal against withdrawal of concession*

There is no appeal to the tax tribunal against a decision by HMRC to withdraw a concession. The CG Manual provides

> **25880. Dispute over binding agreement**
> Where the written contract is made after 5 April following the date of departure an assessment to Capital Gains Tax made for the year of departure will only be supportable if there was a binding oral or written agreement in the year of departure. A dispute on this point can therefore be adjudicated by the Commissioners. If they find as a fact that there was such an agreement in the year of departure they can determine the appeal against the assessment for the year of departure in the appropriate figures. However, if they find there was no agreement they will discharge the assessment.
> **25881.**
> Where the written contract is made after the date of departure but before the following 6 April an assessment to Capital Gains Tax made for the year of departure will be supportable in law whether or not there was a binding agreement predating departure. This is because TCGA 1992, S 2 imposes liability whenever an individual is resident or ordinarily resident for any part of a year of assessment (see CG25200 above). If the disposal occurred in the period after the date of departure but before the following 6 April relief from assessment will only be possible if the individual receives the benefit of ESC D2. Since Commissioners cannot concern themselves with the operation of Extra Statutory Concessions the Commissioners would be unable to discharge an assessment made on gains arising in this period.
> **25882. Dispute over binding agreement**
> If the pre-emigration agreement and the written contract are alleged to have occurred in different months in a case where indexation allowance is due and the retail prices index for those months is different, the amount of indexation allowance to be given in each computation will be different. In such cases, since the amount of the assessment on the two bases differs, it is possible to refer the dispute to the Commissioners for adjudication. If they decide that there was no pre-emigration agreement they can determine the appeal in the amount

appropriate for a disposal occurring on the date of the written contract. Providing the Board did not decide to withhold the benefit of ESC D2 the Inland Revenue would then reduce the amount of the assessment to nil by concession.

This solution (reminiscent of the fictitious actions of common law conveyancing) does not work after the abolition of indexation in 1998: the Manual is a decade out of date.

25883. Dispute over binding agreement [March 2007]
Referring the question of whether a pre-emigration agreement existed to the Commissioners in circumstances where the Board would, in any event, withhold the benefit of ESC D2 could give rise to justifiable criticism of the Revenue. This is because such action by the Board would substantially remove the benefit of any Commissioners' decision made in the individual's favour. You should therefore not list any such case for a contentious appeal hearing on this point until the possibility of withholding the benefit of ESC D2 has been considered in accordance with CG25980 below. When dealing with such cases you should attempt to obtain all facts relevant to a decision on ESC D2 when obtaining facts about the possible existence of a pre-emigration agreement and then submit to Capital Gains Technical Group in appropriate cases.
25884. Dispute over binding agreement [March 2007]
If the pre-emigration agreement and the written contract are alleged to have occurred in the same month (which will frequently occur when there is a very short interval between emigration and contract date) or in different months but the retail prices index for those months is the same, the amount of the assessment would be the same whether or not there was a pre-emigration agreement. As the Commissioners cannot consider the effects of an Extra Statutory Concession they would be bound to determine the assessment at this figure. In these circumstances the dispute about the existence of the pre-emigration agreement could not be resolved by referring the matter to the Commissioners. In such cases, where the taxpayer does not accept that a pre-emigration agreement existed, Capital Gains Technical Group will be pleased to advise on what further action may be taken.

It is possible to challenge HMRC by way of judicial review (or by application to HMRC adjudicator). It is an interesting question whether the taxpayer must show:

(1) the HMRC decision that there is tax avoidance is one which no reasonable person could reach, or merely
(2) the HMRC view is (in the Court's judgment) wrong (even if not unreasonable).

In practice few, if any, cases would turn on that fine distinction and either contention would be difficult to sustain.

6.22 CGT planning before arrival in the UK

There are many possible strategies. A minimum course would be for the individual to dispose of UK situate assets with inherent gains so as to bring their base cost up to market value. This need only apply to UK situate assets which might be disposed of while the individual is resident here. The individual might go further and dispose of non-UK situate assets if he wishes to have the ability to sell the asset and remit the gain.

Watch the pre-owned asset rules: see 55.1 (Pre-owned assets).

These steps would ideally be taken in the tax year before arrival, but simple disposals might if necessary take place in the tax year of arrival, before the date of arrival, if reliance can be placed on ESC D2.

HMRC (rightly) take the point that the "bed and breakfasting" rules apply to a non-resident so he should not dispose of securities and re-acquire securities of the same class within 30 days: s.106A TCGA; RI 226.

Of course foreign tax on the disposal would need to be considered. It is sometimes possible to arrange a disposal which under UK rules takes place while non-resident but under foreign rules takes place while UK resident.

It may be appropriate to make capital payments from UK trusts before becoming UK resident.

6.22.1 *Commentary*

It goes without saying that the ESCs discussed in this chapter ought to be put into legislation. It seems surprising that the government's (absolutely correct) policy of putting ESCs into legislation, which has enacted many ESCs in recent years (including many which are wholly trivial) has overlooked these two concessions, which apply to everyone who comes or leaves the UK. Perhaps that was a deliberate decision. The informal nature of the concessions (supplemented by IR20) allowed HMRC to make significant changes in their operation of ESC A11, without discussion or consultation or even expressly announcing the changes. The concessions can be further amended or indeed withdrawn without notice, consultation, or any Parliamentary sanction.

6.23 Year of acquisition of UK domicile

Tax Bulletin 29 provides:

> In line with current practice, but depending on the circumstances of any particular case, we may only change the basis of assessment from 6 April following the date of change in domicile. Where it is difficult to pinpoint a precise date of change in domicile (and again depending on the circumstances of any particular case), the changes to the basis of assessment may take effect from the 6 April following the date our enquiries are concluded.

This coyly suggests a practice where a UK resident individual concedes the acquisition of a UK domicile of choice, in return for which HMRC will regard the domicile as commencing the following 6 April (and so avoiding all problems of a split domicile year).

CHAPTER SEVEN

EXIT TAXES

7.1 Exit taxes – Introduction

This chapter considers exit taxes, that is, taxes imposed on emigration from the UK by individuals or trustees. Exit taxes on companies are not considered.

7.2 Clawback of hold-over relief on emigration of individual

Section 168(1) TCGA 1992 provides a clawback of hold-over relief on emigration of individuals.

> If—
> (a) relief is given under section 165 in respect of a disposal to an individual or under section 260 in respect of a disposal to an individual ("the relevant disposal"); and
> (b) at a time when he has not disposed of the asset in question, the transferee becomes neither resident nor ordinarily resident in the UK,
>
> then, subject to the following provisions of this section, a chargeable gain shall be deemed to have accrued to the transferee immediately before that time, and its amount shall be equal to the held-over gain (within the meaning of section 165 or 260) on the relevant disposal.

There is scope for planning by the individual becoming treaty non-resident but remaining UK resident. But given the EU issues discussed below, and the CGT temporary non-residence rules, this may not matter much.

7.2.1 *Disposal prior to emigration*

The clawback charge does not apply if the individual disposes of the asset before emigration. Section 168(2) TCGA deals with part disposals:

> For the purposes of subsection (1) above the transferee shall be taken to have disposed of an asset before the time there referred to only if he has made a disposal or disposals in connection with which the whole of the held-over gain on the relevant disposal was represented by reductions made in accordance with section 165(4)(b) or 260(3)(b) and where he has made a disposal in connection with which part of that gain was so represented, the amount of the chargeable gain deemed by virtue of this section to accrue to him shall be correspondingly reduced.

Section 168(3) TCGA provides that inter-spouse disposals are disregarded:

> The disposals by the transferee that are to be taken into account under subsection (2) above shall not include any disposal to which section 58 applies; but where any such disposal is made by the transferee, disposals by his spouse or civil partner shall be taken into account under subsection (2) above as if they had been made by him.

This is obviously right.

7.2.2 *Time limit*

Section 168(4) TCGA contains a time limit:

> Subsection (1) above shall not apply by reason of a person becoming neither resident nor ordinarily resident more than 6 years after the end of the year of assessment in which the relevant disposal was made.

7.2.3 *Relief for short term postings abroad*

Section 168(5) TCGA contains a relief for short term postings abroad:

> Subsection (1) above shall not apply in relation to a disposal made to an individual if—
> (a) the reason for his becoming neither resident nor ordinarily resident in the UK is that he works in an employment or office all the duties of which are performed outside the UK, and
> (b) he again becomes resident or ordinarily resident in the UK within the period of 3 years from the time when he ceases to be so, without

> having meanwhile disposed of the asset in question;
>
> and accordingly no assessment shall be made by virtue of subsection (1) above before the end of that period in any case where the condition in para (a) above is, and the condition in para (b) above may be, satisfied.

Section 168(6) TCGA deals with part disposals and inter-spouse disposals by the short term non-resident. The wording is based on s.168(2)(3) but its effect is different:

> For the purposes of subsection (5) above a person shall be taken to have disposed of an asset if he has made a disposal in connection with which the whole or part of the held-over gain on the relevant disposal would, had he been resident in the UK, have been represented by a reduction made in accordance with section 165(4)(b) or 260(3)(b) ...

This is a strict rule, since even a part disposal loses the benefit of the relief for the entire asset. The subsection continues:

> and subsection (3) above shall have effect for the purposes of this subsection as it has effect for the purposes of subsection (2) above.

Thus there is no exit charge on an asset if T goes non-resident, and gives the asset to his spouse, provided that T becomes UK resident again within 3 years and the spouse does not dispose of the asset during that period. It is irrelevant whether the spouse becomes UK resident.

7.2.4 *Collection of clawback charge from donor*

The tax may be collected from the donor or transferor. This is not usually so important to individual donors (because they will generally be prepared to take a view about the future actions of their donees). It is important for trustees who transfer assets to beneficiaries and wish to claim hold-over relief to avoid a charge under s.71 TCGA 1992. Section 168(7) TCGA provides:

> Where an amount of tax assessed on a transferee by virtue of subsection (1) above is not paid within the period of 12 months beginning with the date when the tax becomes payable then, subject to subsection (8) below, the transferor may be assessed and charged (in the name of the transferee) to all or any part of that tax.

Section 168(8) sets out a time limit:

> No assessment shall be made under subsection (7) above more than 6 years after the end of the year of assessment in which the relevant disposal was made.

Thus a donor who makes a claim for hold-over relief is at risk of a clawback if the donee emigrates within (approximately) 4 years of the gift. Suppose:

(1) In 2001/02 D makes a gift to T, and T emigrates in 2005/06.
(2) The exit charge is payable on 31 January 2007.

D cannot be assessed until 12 months later, 31 January 2008. That is just within "6 years after the end of the year of assessment in which the relevant disposal was made". But if D had made his gift in 2000/01 it would have been too late for HMRC to collect the tax from D.

Section 168(9) TCGA provides an indemnity (for what it may be worth):

> Where the transferor pays an amount of tax in pursuance of subsection (7) above, he shall be entitled to recover a corresponding sum from the transferee.

7.2.5 *Prevention of double charge*

Section 168(10) TCGA provides:

> Gains on disposals made after a chargeable gain has under this section been deemed to accrue by reference to a held-over gain shall be computed without any reduction under section 165(4)(b) or 260(3)(b) in respect of that held-over gain.

This prevents double UK taxation (if the individual later makes a disposal within the charge to CGT, e.g. if he returns to the UK). It does not prevent double taxation if the individual pays foreign tax on the same gain. The EU have noted the issue and recommend member states to act, but the UK has not done anything.

7.3 Clawback of EIS relief

There is a similar clawback of EIS relief if (in short) an individual becomes non-resident (and non-ordinarily resident) within three years of acquiring EIS shares: para 3 Sch 5B TCGA 1992.

7.4 Exit charge for trusts

Section 80 TCGA 1992 provides an exit charge for trusts:

> (1) This section applies if the trustees of a settlement become at any time ("the relevant time") neither resident nor ordinarily resident in the UK.
> (2) The trustees shall be deemed for all purposes of this Act—
> (a) to have disposed of the defined assets immediately before the relevant time, and
> (b) immediately to have reacquired them,
> at their market value at that time.

Unlike the rule for individuals, this applies to all gains, not just held-over gains.

7.4.1 *Defined assets*

"Defined assets" is a label which brings in a number of rules which limit the scope of the charge. Section 80(3) TCGA provides:

> Subject to subsections (4) and (5) below, the defined assets are all assets constituting settled property of the settlement immediately before the relevant time.

7.4.2 *Assets of UK trade*

Section 80(4) TCGA brings in an exception for UK trades:

> If immediately after the relevant time—
> (a) the trustees carry on a trade in the UK through a branch or agency, and
> (b) any assets are situated in the UK and either used in or for the purposes of the trade or used or held for the purposes of the branch

or agency,

the assets falling within para (b) above shall not be defined assets.

7.4.3 *DTT exemption*

Section 80(5) TCGA brings in an exception for assets protected by DTTs:

Assets shall not be defined assets if—

(a) they are of a description specified in any double taxation relief arrangements, and

(b) were the trustees to dispose of them immediately before the relevant time, the trustees would fall to be regarded for the purposes of the arrangements as not liable in the UK to tax on gains accruing to them on the disposal.

7.4.4 *Restriction of roll-over relief*

Section 80 TCGA provides:

(6) Section 152 shall not apply where the trustees—

(a) have disposed of the old assets, or their interest in them, before the relevant time, and

(b) acquire the new assets, or their interest in them, after that time, unless the new assets are excepted from this subsection by subsection (7) below.

(7) If at the time when the new assets are acquired—

(a) the trustees carry on a trade in the UK through a branch or agency, and

(b) any new assets are situated in the UK and either used in or for the purposes of the trade or used or held for the purposes of the branch or agency,

the assets falling within para (b) above shall be excepted from subsection (6) above.

(8) In this section "the old assets" and "the new assets" have the same meanings as in section 152.

The CG Manual explains:

38357. Roll-over relief

Section 80(6) prevents roll-over relief under TCGA 1992, s.152 from applying so as to avoid the new exit charge where trustees dispose of assets before, then acquire new assets after becoming non-resident where the new assets are outside the UK tax charge.

7.4.5 *Accidental emigration on death of trustee*

Section 81 TCGA 1992 provides:

> **81 Death of trustee: special rules**
> (1) Subsection (2) below applies where—
> (a) section 80 applies as a result of the death of a trustee of the settlement, and
> (b) within the period of 6 months beginning with the death, the trustees of the settlement become resident and ordinarily resident in the UK.

This could apply if for instance a trust has a UK and a foreign trustee, and the UK trustee dies.

> (2) That section shall apply as if the defined assets were restricted to such assets (if any) as—
> (a) would be defined assets apart from this section, and
> (b) fall within subsection (3) or (4) below.

That is, there is no charge apart from the exceptional cases of (3) and (4). Section 81(3) TCGA provides:

> Assets fall within this subsection if they were disposed of by the trustees in the period which—
> (a) begins with the death, and
> (b) ends when the trustees become resident and ordinarily resident in the UK.

Since the trust will be UK resident in the year and subject to CGT on its gains, it is difficult to see the point of this. Section 81(4) TCGA provides:

> Assets fall within this subsection if—
> (a) they are of a description specified in any double taxation relief arrangements,
> (b) they constitute settled property of the settlement at the time immediately after the trustees become resident and ordinarily resident in the UK, and

(c) were the trustees to dispose of them at that time, the trustees would fall to be regarded for the purposes of the arrangements as not liable in the UK to tax on gains accruing to them on the disposal.

7.4.6 *Accidental immigration on death of trustee*

Section 81 goes on to give a relief where there has been an accidental immigration to the UK followed by emigration:

(5) Subsection (6) below applies where—
(a) at any time the trustees of a settlement become resident and ordinarily resident in the UK as a result of the death of a trustee of the settlement, and
(b) section 80 applies as regards the trustees of the settlement in circumstances where the relevant time (within the meaning of that section) falls within the period of 6 months beginning with the death.
(6) That section shall apply as if the defined assets were restricted to such assets (if any) as—
(a) would be defined assets apart from this section, and
(b) fall within subsection (7) below.

There is only one exceptional case:

(7) Assets fall within this subsection if—
(a) the trustees acquired them in the period beginning with the death and ending with the relevant time, and
(b) they acquired them as a result of a disposal in respect of which relief is given under section 165 or in relation to which section 260(3) applies.

This is only a limited relief, since it does not avoid the CGT charge on actual disposals of assets by the trustees in a year when accidentally UK resident.

7.4.7 *Collection of exit charge from former trustee*

Section 82 TCGA provides:

82 Past trustees: liability for tax
(1) This section applies where—

(a) section 80 applies as regards the trustees of a settlement ("the migrating trustees"), and
(b) any capital gains tax which is payable by the migrating trustees by virtue of section 80(2) is not paid within 6 months from the time when it became payable.

(2) The Board may, at any time before the end of the period of 3 years beginning with the time when the amount of the tax is finally determined, serve on any person to whom subsection (3) below applies a notice—
(a) stating particulars of the tax payable, the amount remaining unpaid and the date when it became payable;
(b) stating particulars of any interest payable on the tax, any amount remaining unpaid and the date when it became payable;
(c) requiring that person to pay the amount of the unpaid tax, or the aggregate amount of the unpaid tax and the unpaid interest, within 30 days of the service of the notice.

(3) This subsection applies to any person who, at any time within the relevant period, was a trustee of the settlement, except that it does not apply to any such person if—
(a) he ceased to be a trustee of the settlement before the end of the relevant period, and
(b) he shows that, when he ceased to be a trustee of the settlement, there was no proposal that the trustees might become neither resident nor ordinarily resident in the UK.

(4) Any amount which a person is required to pay by a notice under this section may be recovered from him as if it were tax due and duly demanded of him; and he may recover any such amount paid by him from the migrating trustees.

(5) A payment in pursuance of a notice under this section shall not be allowed as a deduction in computing any income, profits or losses for any tax purposes.

(6) For the purposes of this section—
(a) where the relevant time (within the meaning of section 80) falls within the period of 12 months beginning with 19th March 1991, the relevant period is the period beginning with that date and ending with that time;
(b) in any other case, the relevant period is the period of 12 months ending with the relevant time.

7.5 Charge on trust becoming treaty non-resident

Section 83 TCGA 1992 provides:

83 Trustees ceasing to be liable to UK tax

(1) This section applies if the trustees of a settlement, while continuing to be resident and ordinarily resident in the UK, become at any time ("the time concerned") trustees who fall to be regarded for the purposes of any double taxation relief arrangements—

(a) as resident in a territory outside the UK, and

(b) as not liable in the UK to tax on gains accruing on disposals of assets ("relevant assets") which constitute settled property of the settlement and fall within descriptions specified in the arrangements.

(2) The trustees shall be deemed for all purposes of this Act—

(a) to have disposed of their relevant assets immediately before the time concerned, and

(b) immediately to have reacquired them,

at their market value at that time.

This charge does not contain any of the exceptions applicable to the s.80 exit charge.

7.5.1 *Restriction of roll-over relief*

Section 84 TCGA provides:

84 Acquisition by dual resident trustees

(1) Section 152 shall not apply where—

(a) the new assets are, or the interest in them is, acquired by the trustees of a settlement,

(b) at the time of the acquisition the trustees are resident and ordinarily resident in the UK and fall to be regarded for the purposes of any double taxation relief arrangements as resident in a territory outside the UK,

(c) the assets are of a description specified in the arrangements, and

(d) were the trustees to dispose of the assets immediately after the acquisition, the trustees would fall to be regarded for the purposes of the arrangements as not liable in the UK to tax on gains accruing to them on the disposal.

(2) In this section "the new assets" has the same meaning as in section 152.

7.6 Migration of individual trader[20]

Section 17 ITTOIA provides:

17 Effect of becoming or ceasing to be a UK resident
(1) This section applies if—
(a) an individual carries on a trade wholly or partly outside the UK otherwise than in partnership, and
(b) the individual becomes or ceases to be UK resident.
(2) The individual is treated for income tax purposes—
(a) as permanently ceasing to carry on the trade at the time of the change of residence, and
(b) so far as the individual continues to carry on the trade, as starting to carry on a new trade immediately afterwards....

The Business Income Manual provides:

70610. Changes in residence status [February 2007]
[The Manual summarises s.17 ITTOIA and continues:]
As there is no provision in the Taxes Acts for splitting a tax year in relation to residence, the deemed cessation and recommencement should strictly take place at the start of the tax year in which the taxpayer became resident in the UK or the end of the tax year in which the taxpayer ceased to be resident. But under ESC/A11, the business is treated as ceasing and recommencing on the actual date of arrival or departure if the taxpayer so chooses and the conditions of the ESC are met.
This rule does not apply to individuals carrying on a trade in partnership, but there are instead special provisions on how non-resident partners are taxed on their share of partnership profits (ITH1664).

For the equivalent rules for partnerships, see s.852(6) ITA:

If—
(a) the firm carries on the actual trade wholly or partly outside the United Kingdom, and
(b) the partner becomes or ceases to be UK resident,
the partner is treated as permanently ceasing to carry on one notional

20 References in this paragraph to a trade include a profession or vocation, since there is no difference between them.

trade when the change of residence occurs and starting to carry on another immediately afterwards.

7.7 EU restriction on exit taxes

7.7.1 *Exit charge on emigration of individual to EU state*

An EU communication on exit taxes[21] provides:

2. EXIT TAXES: LEGAL FRAMEWORK

2.1. The decision of the ECJ in *de Lasteyrie*[22] and its implications for individuals

On 11 March 2004, the ECJ gave an important interpretation of the freedom of establishment in the context of French legislation taxing unrealised increases in value of securities where individual taxpayers move their tax residence outside France. When Mr. de Lasteyrie du Saillant in 1998 moved from France to Belgium, he was subject to immediate taxation on the unrealised increase in value of the shares which he held in a French company.

The ECJ held that the French provision in question was likely to restrict the exercise of the freedom of establishment, having at the very least a dissuasive effect on taxpayers wishing to establish themselves in another MS, because they were subjected in the exit country, by the mere fact of transferring their tax residence outside France, to tax on a form of income that had not yet been realised, and thus to disadvantageous treatment by comparison with a person maintaining his residence in France.

Although the ruling in *de Lasteyrie* relates to the facts and circumstances of the case at issue, the ECJ's interpretation of EC Law implies conclusions as regards exit taxes in general.

Taxing residents on a realisation basis and departing residents on an accruals basis is a difference in treatment which constitutes an obstacle to free movement. Where a MS decides to assert a right to tax gains accrued during a taxpayer's residence within its territory, it cannot take

21 "Exit taxation and the need for co-ordination of Member States' tax policies" 19.12.2006 COM(2006) 825 final, accessible *http://ec.europa.eu/taxation_customs/resources/documents/taxation/COM(2006) 825_en.pdf.*

22 Case C-9/02 *Hughes de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie,* OJ C 94, 17.04.2004, p. 5.

> measures which present a restriction to free movement.
> This rules out the possibility of immediate collection of the tax due on the unrealised gains when taxpayers move their tax residence to another MS.

The communication then considers permitted forms of charges on departing residents (not applicable in the UK)[23] and concludes:

> Most MSs which had exit tax rules on individual shareholders similar to those at issue in *de Lasteyrie* have since abolished or amended them in line with the ruling. This has enabled the Commission to suspend infringement proceedings against a number of MSs on this particular aspect. The Commission will, however, continue to monitor MSs' rules in this area with a view to ensuring their EC law compatibility.

The UK has three exit charges on individuals, the hold-over clawback, the EIS clawback, and the charge on migrating traders so far they seem to have escaped direct EU attention. If the migration is to a member state, these can hardly be described as consistent with EU law, freedom of

23 "The ECJ ruled in *de Lasteyrie* and in *N* [Case c-470/04 *N v Inspecteur van de Belastningsdienst* Oost/kantoor Almelo, 7 September 2006] that the possible suspension of payment made subject, for example, to conditions that guarantees must be provided, constitutes a restrictive effect in that the taxpayer is deprived of enjoyment of the assets given as a guarantee. Similarly, it is clear from *de Lasteyrie* that suspension of payment cannot be made subject to the condition of designating a representative in the MS of origin. In general, any means of preserving the tax claim must be strictly proportional to that aim and must not entail disproportionate costs for the taxpayer.
As the ECJ confirmed in *N*, when a resident of a MS transfers his/her residence to another MS, the MS from which he/she departs is not prevented by EC law from assessing the amount of income on which it wishes to preserve its tax jurisdiction, provided this does not give rise to an immediate charge to tax and that there are no further conditions attached to the deferral. Such a practice is in line with the principle of fiscal territoriality, connected with a temporal component, namely residence within the territory during the period in which the taxable profit arises. A requirement, that the taxpayer submits a tax declaration at the time of the transfer of residence, necessary for the purpose of assessing the income, can be considered proportionate having regard to the legitimate objective of allocating the taxing powers, in particular so as to eliminate double taxation, between the MSs."
Case C-470/04 *N v Inspecteur van de Belastningsdienst* Oost/kantoor Almelo, 7 September 2006.

establishment[24] and freedom to reside.[25]

7.7.2 *Exit charge on emigration of trust to EU state*

What about the exit charge for trusts? The EU communication does not discuss trusts, but it does discuss companies:

> **3.1. Implications of *de Lasteyrie* for companies**
> The Commission is of the opinion that the interpretation of the freedom of establishment given by the ECJ in *de Lasteyrie* in respect of exit tax rules on individuals also has direct implications for MSs' exit tax rules on companies.

This is obviously correct since freedom of establishment applies to companies as well as individuals.[26] The same will apply to a trust if it is an "undertaking" within the meaning of the freedom of establishment rule.[27]

7.7.3 *Exit charge on emigration to EEA state*[28]

The EU communication continues:

> **4.1. Freedoms applicable to EEA-states**
> The European Economic Area (EEA) Agreement provides for the same four basic freedoms as the EC Treaty (goods, persons, services and capital). It also includes horizontal provisions relevant to the four freedoms. Secondary Community legislation in the area of taxation, however, has not been incorporated in the EEA Agreement. The Mutual Assistance Directive and the Recovery Directive therefore do not apply to these states

24 See 42.2 (Freedom of establishment).

25 Art. 18 EC provides:

> "Every citizen of the Union shall have the right to move and reside freely within the territory of the Member States, subject to the limitations and conditions laid down in this Treaty and by the measures adopted to give it effect."

26 See 42.2 (Freedom of establishment).

27 See 42.8 (Section 86 TCGA). Where trustees are individuals, the EU freedom of residence might be in point.

28 The states within the EEA (European Economic Area) are Norway, Iceland and Liechtenstein.

> **4.2. Emigration of individuals/transfer of seat of companies – free movement of workers/freedom of establishment**
> Taxes levied in case of the emigration of individuals or the transfer of seat of companies would primarily appear to involve the free movement of workers (Article 39 EC/28 EEA Agreement) and the freedom of establishment (Article 43 EC/31 EEA Agreement) respectively. The exit taxes at issue in *de Lasteyrie* and *N* which applied to individuals with substantial shareholdings were found to contravene the freedom of establishment. As the same basic freedoms apply to EEA states, the rulings in *de Lasteyrie* and *N* are of direct relevance to them. The question is whether there are significant differences in situation which could justify such restrictions in the case of EEA states. The Commission is of the opinion that an immediate collection of tax may be justified in certain circumstances by overriding reasons in the general interest, in particular the need to ensure the effectiveness of fiscal supervision and to prevent tax evasion.
> EEA states are not obliged to implement secondary Community legislation in the area of taxation, such as the Mutual Assistance Directive and the Recovery Directive. As a consequence, MSs do not necessarily have the same guarantees that deferred tax claims can be discharged at a later stage as they would have within the Community. In many cases, MSs have, however, concluded bilateral or multilateral tax conventions with EEA states which include information exchange obligations that provide for an equivalent level of mutual assistance. The Commission believes that in situations where a lack of administrative cooperation prevents MSs from safeguarding their tax claims they should be entitled to take appropriate measures at the moment of emigration or transfer.

In the case of an emigration to an EEA state, it would be necessary to review the treaties between the UK and that state in order to ascertain the position.

7.7.4 *Exit charge on emigration to other countries*

The EU communication continues:

> **5. EXIT TAXES IN RESPECT OF THIRD COUNTRIES**
> Of the four basic freedoms, only the free movement of capital and payments (Article 56) applies to third countries.
> In respect of the emigration or transfer of seat to other third countries

> as such, the provisions on the free movement of persons do not apply and MSs remain free to assess and collect their taxes at the moment of departure. However, the emigration of an individual or the transfer of seat of a company may involve transactions which are covered by the provisions on the free movement of capital. The transfer of assets to a PE in a third country may also fall to be examined from the perspective of the free movement of capital.
>
> Since the result of the application of the different freedoms should be the same, it would appear that an immediate collection of tax at the moment of transfer of such assets constitutes a restriction on the free movement of capital. However, as noted above, the Commission believes that a lack of administrative co-operation may justify a restriction in these circumstances. The Commission would encourage MSs, where appropriate, to enhance administrative co-operation with their non-EU partners, as this is the best means of ensuring tax compliance and preventing tax evasion.

The European Parliament supports this view.[29]

In the case of an emigration to a third country (not a MS or EEA state), it would be necessary to review the treaties between the UK and that state in order to ascertain the position.

29 European Parliament resolution of 24 October 2007 on the contribution of taxation and customs policies to the Lisbon Strategy.

CHAPTER EIGHT

TEMPORARY NON-RESIDENCE

8.1 Temporary non-residence – Introduction

I use the term **"treaty-residence"** to mean residence for the purposes of a DTT, and "**domestic-law residence"** residence for UK tax purposes (it is essential in this chapter to distinguish the two.) Where a person is resident in the UK for UK law purposes, I describe them as **"domestic-law UK resident."** Where a person is treaty-resident outside the UK, I adopt the statutory terminology "treaty non-resident" though it might be clearer to say "treaty-resident outside the UK" because a person who is treaty non-resident must be resident in the treaty jurisdiction for the purposes of the treaty. These are all clumsy terms but it is difficult to think of much better.

Until 1998, a possible method of CGT planning was as follows. An individual ceased to be domestic law UK resident and disposed of assets during a year of non-residence; in the following tax year he could become UK resident again. Thus relatively brief periods of domestic law non-residence offered the opportunity of CGT-free disposals. Section 10A(2) TCGA is intended to prevent this.

Until 2005, a variant of this planning was: an individual remained domestic law UK resident but became treaty non-resident (ie treaty-resident in a state with a DTT conferring CGT relief); the individual disposed of assets while treaty non-resident; following the disposal the individual could cease to be treaty non-resident. Thus relatively brief periods of treaty non-residence offered the opportunity of CGT-free disposals (so far as treaty relief could be available). Section 10A(2) TCGA is intended to prevent this. Unfortunately the drafter did not realise that (in some cases) treaty relief is not available, so there the provisions has a number of anomalies.

Similarly, until 2008 a possible method of remittance planning was as follows. Suppose an individual had income or gains taxable on remittance (in this chapter called "pre-departure income or gains"). The individual cased to be domestic-law UK resident, and remitted the income or gains to the UK during the year of non-residence.

(A theoretical variant of this planning might be: an individual remained UK resident but became treaty-resident in a state with a DTT conferring the necessary relief (ie "treaty non-resident"); the individual remitted the income or gains while treaty non-resident; following the remittance the individual could cease to be treaty non-resident. However treaties do not provide relief in this situation.)

Thus relatively brief periods of non-residence offered a remittance basis taxpayer the opportunity of tax free remittances. This is countered by s.832A ITTOIA (for income). This provision was based on the existing s.10A which was designed for a different situation, resulting in more anomalies.

The drafter of s.832A used s.10A as a precedent (though simplifying the wording in accordance with the principles of plain English drafting). Where the differences are not material, I give the text of the CGT provision in the text and the ITTOIA provision in a footnote.

8.2 Temporary non-resident conditions

Section 10A TCGA sets out four conditions which must all be satisfied if the section is to take effect. I refer to these as the "**temporary non-resident conditions**". Section 10A(1) TCGA provides:

> This section applies in the case of any individual ("the taxpayer") if—
> (a) he satisfies the residence requirements for any year of assessment ("the year of return");
> (b) [i] he did not satisfy those requirements for one or more years of assessment immediately preceding the year of return but
> [ii] there are years of assessment before that year for which he did satisfy those requirements;[1]
> (c) there are fewer than five years of assessment falling between the year of departure and the year of return; and
> (d) four out of the seven years of assessment immediately preceding the

1 Limb [ii] appears to be otiose, given para (d); but it does not matter.

year of departure are also years of assessment for each of which he satisfied those requirements.

Section 832A(1) ITTOIA is the same for IT.[2]
The legalisation uses three defined terms with commonsense definitions:

(1) Year of departure.[3]
(2) Intervening year.[4]
(3) Year of return (defined in s.10A(1)(a).)

The conditions allow (indeed invite) tax planning by ensuring that a person does not satisfy the residence requirements for at least a five year period. The way to do this is
(1) to be non-resident; or
(2) if UK resident, to be treaty non-resident
for a five year period.

These rules can give rise to an exit charge which is in some cases at least not compatible with EU law.

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2 Section 832A(1) ITTOIA provides:

> "This section applies if—
> (a) an individual satisfies the residence requirements for any tax year ("the year of return"),
> (b) the individual did not satisfy those requirements for one or more tax years immediately before the year of return but did satisfy those requirements for an earlier tax year,
> (c) there are fewer than 5 tax years between—
> (i) the last tax year before the year of return for which the individual satisfied those requirements ("the year of departure"), and
> (ii) the year of return, and
> (d) the individual satisfied those requirements for at least 4 out of the 7 tax years immediately before the year of departure."

3 Section 10A(8) TCGA provides:

> "the year of departure" means the last year of assessment before the year of return for which the taxpayer satisfied the residence requirements.

4 Section 10A(8) TCGA provides:

> 'intervening year' means any year of assessment which, in a case where the conditions in paras (a) to (d) of subsection (1) above are satisfied, falls between the year of departure and the year of return.

That is, an intervening year is one in which the temporary non-resident conditions are satisfied.

8.3 "Residence requirements"

"Residence requirements" is defined in s.10A(9) TCGA:

> For the purposes of this section an individual satisfies the residence requirements for a year of assessment—
> (a) if, during any part of that year of assessment, he is resident in the UK and not Treaty non-resident, or
> (b) if he is ordinarily resident in the UK during that year of assessment, unless he is Treaty non-resident during that year of assessment.

Section 832A(4) ITTOIA is the same for IT.[5]

One has to read s.10A(9) more than once, to assimilate the double negatives (s.832A(4) is better drafted), but the matter can be set out in a table:

Resident	**Ordinary Resident**	**Treaty non-resident**	**Residence Requirements met**
Y	Not relevant	N	Y
Y	Not relevant	Y	N
Not relevant	Y	N	Y
Not relevant	Y	Y	N
N	N	Not relevant	N

Section 10A(9)(b) only applies to the theoretical case of a person who is non-resident but ordinarily resident.

5 Section 832A(4) ITTOIA provides:

> "For the purposes of subsection (1) an individual "satisfies the residence requirements" for a tax year if—
> (a) at any time in that year, the individual is UK resident and not Treaty non-resident, or
> (b) the individual is ordinarily UK resident, and is not Treaty non-resident, for that year."

8.3.1 "*Treaty non-resident*"

"Treaty non-resident" is defined for CGT in s.288(7B) TCGA:

> For the purposes of this Act, a person is Treaty non-resident at any time if, at that time, he falls to be regarded as resident in a territory outside the UK for the purposes of double taxation relief arrangements having effect at that time.

Section 832A(5) is the same for IT.[6]

The key term is "double taxation relief arrangements" (here called "DTR arrangements").

8.3.2 *"DTR arrangements" - IT*

Section 832A(6) ITTOIA defines DTR arrangements for the purposes of the IT provision:

> In subsection (5) "double taxation relief arrangements" means arrangements specified in an Order in Council making any such provisions as are referred to in section 788 of ICTA.[7]

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6 Section 832A(5) ITTOIA provides:

> "For the purposes of subsection (4) an individual is "Treaty non-resident" at any time if, at that time, he is regarded as resident in a territory outside the UK for the purposes of double taxation relief arrangements having effect at that time."

7 This is a reference to s.788(3) ICTA which provides (so far as relevant):
(3) ... the arrangements shall ... have effect in relation to income tax and corporation tax in so far as they provide—
(a) for relief from income tax, or from corporation tax in respect of income or chargeable gains; or
(b) for charging the income arising from sources, or chargeable gains accruing on the disposal of assets, in the UK to persons not resident in the UK; or
(c) for determining the income or chargeable gains to be attributed—
(i) to persons not resident in the UK and their agencies, branches or establishments in the UK; or
(ii) to persons resident in the UK who have special relationships with persons not so resident; or
(d) for conferring on persons not resident in the UK the right to a tax credit under section 397(1) of ITTOIA 2005 in respect of qualifying distributions made to them by companies which are so resident.

8.3.3 *"DTR arrangements" - CGT*

Section 288(1) TCGA defines double taxation relief arrangements ("DTR arrangements") for the purpose of CGT:

> "double taxation relief arrangements" means, in relation to a company, arrangements having effect by virtue of section 788 of the Taxes Act and, in relation to any other person, means arrangements having effect by virtue of that section as extended to capital gains tax by section 277.

This is different from the IT provision because the treaty needs to contain a CGT provision. For instance, the Jersey DTT counts as "DTR arrangements" for IT but not for CGT.

8.4 Effect of satisfying temporary non-resident conditions

There are two distinct rules:
(1) Gains and losses accruing in intervening years: s.10A(2).
(2) Pre-departure income remitted during intervening years: s.832A.

8.5 Gains & losses accruing in intervening years

Section 10A(2) sets out the consequence if the four temporary non-resident conditions are met:

> Subject to the following provisions of this section and section 86A, the taxpayer shall be chargeable to CGT as if—
> (a) all the chargeable gains and losses which (apart from this subsection) would have accrued to him in an intervening year,
> (b) all the chargeable gains which under section 13 or 86 would be treated as having accrued to him in an intervening year if he had been resident in the UK throughout that intervening year ...[8]
> were gains or, as the case may be, losses accruing to the taxpayer in the year of return.

8 S.10A(2)(c) deals with losses of non-resident companies, see 8.10.1 (Losses of non-resident company within s.13 TCGA).

Para (b) is necessary because chargeable gains on disposals of assets do in principle accrue to individuals even if they are non-resident; but s.13 and s.86 gains do not accrue to participators or settlors who are non-resident. If the individual qualifies for the remittance basis in the year of return, the gains qualify for the remittance basis.

Section 10A(2) is a deeming provision. Gains which actually accrued in an intervening year are deemed to have accrued in the year of return. I refer to this as "**the s.10A(2) fiction**". Applying the s.10A(2) fiction the intervening year gains are in principle taxable in the year of return.

Losses can be carried back, ie losses accruing in a later intervening year can be set against gains accruing in an earlier intervening year.

8.6 Interaction with remittance basis

For a remittance basis taxpayer there could be a conflict between two deeming rules:

(1) Section 12 TCGA (the CGT remittance basis) provides that gains are treated as accruing when remitted;

(2) Section 10A(2) which provides that gains are treated as accruing in the year of return.

Section 10A(9ZA) TCGA provides:

> If—
> (a) section 809B 809D or 809E of ITA 2007 (remittance basis) applies to the taxpayer for the year of return, and
> (b) the taxpayer is not domiciled in the UK in that year,
> any foreign chargeable gains[9] falling within subsection (2)(a) which were remitted in an intervening year are treated as remitted in the year of return.

This only applies to gains "falling within subsection (2)(a) that is:

> chargeable gains ... which (apart from subsection 2(a)) would have accrued to him in an intervening year,

9 Section 10A(9ZA) adds: "For this purpose "foreign chargeable gains" has the meaning given by section 12(4)." If there were a TCGA-wide definition this would not be necessary.

That is, gains accruing in an intervening year and remitted during an intervening year: they are treated as accruing in the year of return, not when remitted. It is an interesting question how to treat gains accruing in an intervening year and not remitted until after the year of return.

I had previously considered that s.10A(9ZA) applied to pre-departure gains (foreign gains accruing while the individual was UK resident, ie gains before departure) which were remitted during the intervening years, but on reflection that does not appear to be the case.

8.6.1 *Transitional rules*

It is considered that until 2008/9 pre-departure gains remitted in an intervening year were not taxed. Para 80(3) Sch 7 FA 2008 provides:

> Nothing in section 10A of TCGA 1992 applies in relation to any part of the gain remitted to the UK in the tax year 2007-08 or any earlier tax year.

Thus pre-2008 gains are caught by the new rule if remitted after 2008/9.

8.6.2 Treaty non-residents

Section 10A(9B) TCGA provides:

> (9B) Where this section applies in the case of any individual in circumstances in which one or more intervening years would, but for his being Treaty non-resident during some or all of that year or those years, not be an intervening year, ...

That is a case of an individual who is domestic-law UK resident but treaty non-resident. The position such individuals is different from those who are not domestic-law UK resident, since they are subject to CGT unless treaty relief applies. Where no treaty-relief applies, there is no need for the temporary non-resident provisions, and the rules should have been disapplied. Instead the rules are disapplied in a more complex manner and the provisions have not been fully thought through.

Subsection 9B goes on to make four modifications to s.10A:

> this section shall have effect in the taxpayer's case—
> (a) as if subsection (2)(a) above did not apply in the case of any amount

> treated by virtue of section 87 or 89(2) as an amount of chargeable gains accruing to the taxpayer in any such intervening year,

Section 10A(9B)(a) disapplies the temporary non-residence rules for s.87 deemed gains: such gains accrue in the year that the s.87 code provides (under the s.87 matching rules and s.87 remittance basis) and not in the year of return. This is sensible on the view (taken in this book) that such gains do not qualify for DT exemption.

Secondly:

> this section shall have effect in the taxpayer's case ...
> (b) as if any such intervening year were not an intervening year for the purposes of subsections (2)(b) and (c) and (6) above.

There are three amendments here are best considered separately. To follow the first we need to refer back to s.10A(2)(b):

> Subject to the following provisions of this section and section 86A, the taxpayer shall be chargeable to CGT as if—
> (b) all the chargeable gains which under section 13 or 86 would be treated as having accrued to him in an intervening year if he had been resident in the UK throughout that intervening year ...
> were gains ...accruing to the taxpayer in the year of return.

Section 10A(9B)(b) disapplies the temporary non-residence rules for s.13 deemed gains: such gains accrue in the year that the s.13 code provides (the year of accrual, subject to the s.13 remittance basis) and not in the year of return. Similarly, the subsection disapplies the temporary non-residence rules for s.86 deemed gains: such gains accrue in the year that s.86 provides (the year of accrual) and not in the year of return. This is sensible on the view that s.13 deemed gains and s.86 deemed gains do not qualify for DT exemption but in some cases they do.

The other amendments made by s.10A(9B)(b) concern s.10A(2)(c) and s.10A(6): this is a consequential amendments relating to losses.[10]

What about gains of an individual who is domestic law UK resident, treaty non-resident, but which do not qualify for treaty relief (eg gains on a disposal of UK land)? They fall within the temporary non-resident rules,

10 See 8.10.1 (Losses of non-resident company within s.13 TCGA).

so the gain accrues in the year of disposal (and tax is paid) but it accrues instead in the year of return (and the former computation is revised, and tax paid or repaid accordingly).

8.7 Pre-departure income

In the following discussion **"pre-departure income"** means foreign income accruing while the individual was UK resident (ie income accruing before departure). It is assumed that the income was not remitted prior to departure (so was not subject to tax).

Section 832A(2) ITTOIA sets out the consequence if the temporary non-resident conditions are met:

> Treat any of the individual's relevant foreign income within subsection (3) which is remitted to the UK after the year of departure and before the year of return as remitted to the UK in the year of return.

This takes us to s.832A(3) which provides:

> (3) Relevant foreign income is within this subsection if—
> (a) it is for the year of departure or any earlier tax year,[11] and
> (b) section 832 applies to it.

Income arising after the year of departure is not caught. Pre-departure income which is remitted during an intervening year is treated as remitted in the year of return. This makes sense for an individual who is not domestic-law UK resident during the intervening year. It makes no sense for someone who is domestic law UK resident but treaty non-resident, unless one takes the view that treaty relief is available on remitted income during the intervening year, which would not seem to be the case.

In the case of an individual who is not domestic-law UK resident, Gift aid relief for donations to charity made during the non-resident period cannot be set against foreign income or gains accruing during the non-resident period, but relief would be available for donations made in the year of return.

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11 "Any earlier year" would include a year in which a person was non-resident, but income of such a year is not relevant foreign income; see 9.3.1 (Relevant foreign income).

8.7.1 *Transitional rules*

Para 83(4) Sch 7 FA 2008 provides:

> Nothing in section 832A of that Act applies in relation to anything remitted to the UK in the tax year 2007-08 or any earlier tax year.

Thus pre-2008 income is caught by the new rule if remitted after 2008/9.

8.8 Interaction with double taxation relief

8.8.1 *DT exemption*

Most DTTs with a capital gains article broadly adopt the OECD Model form:

> Gains from the alienation of any property, other than [specified exceptions] shall be taxable only in the Contracting State of which the alienator is a resident.

Gains accruing when treaty non-resident appear in principle to qualify for this relief even if within the scope of s.10A. However s.10A(9C) provides:

> Nothing in any double taxation relief arrangements shall be read as preventing the taxpayer from being chargeable to capital gains tax in respect of any of the chargeable gains treated by virtue of subsection (2)(a) above as accruing to the taxpayer in the year of return (or as preventing a charge to that tax from arising as a result).

This appears to be a breach of any treaty in OECD Model form.[12]

12 This is recognised in many treaties, which have an additional provision specifically to authorise a s.10A charge (and any foreign state's equivalent):
"(6)The provisions of paragraph 5 of this Article shall not affect the right of a Contracting State to levy according to its law a tax on gains from the alienation of any property derived by an individual who is a resident of the other Contracting State and has been a resident of the first-mentioned Contracting State at any time during the six years immediately preceding the alienation of the property."

However the intention of Parliament is reasonably clear and that prevails over the treaty.[13]

8.8.2 *Foreign tax credit relief*

EN FB 2005 provides:

> The application of section 10A in relation to an individual does not prevent the individual obtaining relief for foreign tax paid in respect of chargeable gains which are treated as arising to him or her in the year of return (see paragraph 12 below).

8.9 Post-departure acquisitions

Section 10A(3) TCGA provides:

> Subject to subsection (4) below, the gains and losses which by virtue of subsection (2) above are to be treated as accruing to the taxpayer in the year of return shall not include any gain or loss accruing on the disposal by the taxpayer of any asset if—
> (a) that asset was acquired by the taxpayer at a time in the year of departure or any intervening year when—
> (i) he was neither resident nor ordinarily resident in the UK, or
> (ii) he was resident or ordinarily resident in the UK but was Treaty non-resident; ...

The CG Manual provides:

> **26230. Gains (or losses) excluded from charge** [October 2004]
> Section 10A(3)(a) TCGA 1992 provides that a gain or loss on an asset that was acquired after departure from the UK in either the tax year of departure or any of the intervening tax years when the taxpayer was not resident or not ordinarily resident shall not be treated as chargeable in the tax year of return.
> **Example**
> Mr Smith, who has lived all his life in the UK, leaves the UK on 10 July 1998 for a four year contract of employment abroad.
> He resumes tax residence in the UK on 15 August 2002.
> On 8 May 1999 Mr Smith buys 20,000 shares in a UK Company. He sells all of the shares on 10 January 2001, realising a gain of £12,000.
> Mr Smith fulfils all of the conditions for Section 10A to apply, but because the

13 *Padmore (No 2) v IRC* 73 TC 470.

> shares were acquired after his departure from the UK the gain is *not* treated as chargeable in the year of return.
>
> **26231. Exclusions** [October 2004]
>
> You should note that the exclusions apply only to gains or losses chargeable or allowable for the intervening years by virtue of Section 10A TCGA 1992. Where assets are acquired after the date of departure and disposed of in the year of departure or year of return while the individual is not resident and not ordinarily resident the gains will be chargeable under Section 2 TCGA 1992 unless split-year treatment under ESC D2 is available to the individual, see CG26300+.

8.9.1 *Exceptions to relief*

The CG Manual provides:

> **26240. Exceptions to the exclusion**
>
> Some assets acquired by an individual after departure from the UK in either the tax year of departure or any of the intervening tax years when the taxpayer was not resident or not ordinarily resident have a connection with the earlier period of residence. Where such assets are acquired in certain specified transactions, see CG26241, or where the cost of acquisition was subject to particular legislation, see CG26250, any gains or losses on the disposal of such assets during the period of temporary non residence are treated as chargeable in the tax year of return.

There are three categories of exceptions. Section 10A(3)(b) TCGA requires:

> (b) that asset was so acquired otherwise than by means of a relevant disposal which by virtue of section 58, 73 or 258(4) is treated as having been a disposal on which neither a gain nor a loss accrued;

The CG Manual explains:

> **26241. Specified acquisitions** [March 2006]
>
> The specified acquisitions are
>
> - assets acquired from another person who acquired them when tax resident in the UK but did not pay tax on their disposal because of no gain/no loss treatment under:
>   - Section 58 TCGA 1992 (transfers between husband and wife or between civil partners), or
>   - Section 73 TCGA 1992 (death of life tenant), or
>   - Section 258(4) TCGA 1992 (works of art)

Section 10A(3)(c) TCGA requires:

> (c) that asset is not an interest created by or arising under a settlement;

This prevents an avoidance scheme under which T would acquire an interest under a settlement with relevant income or trust gains, and then sell the interest tax free.

Lastly, s.10A(3)(d) requires:

> (d) the amount or value of the consideration for the acquisition of that asset by the taxpayer does not fall, by reference to any relevant disposal, to be treated as reduced under section 23(4)(b) or (5)(b), 152(1)(b), 153(1)(b), 162(3)(b) or 247(2)(b) or (3)(b).

The CG Manual provides:

- assets where the acquisition cost of the asset is reduced by a Capital Gains Tax roll-over relief being given on the disposal of another asset which had been acquired by the taxpayer whilst UK resident. The roll-over reliefs to which this section refers are:
  - Section 23(4)(b) TCGA 1992 or Section 23(5)(b)[14] TCGA 1992 (compensation and insurance), see CG15701+
  - Section 152(1)(b) TCGA 1992 (business assets roll-over relief), see CG60250+
  - Section 162(3)(b) TCGA 1992 (transfer of business to a company), see CG65700+
  - Section 247(2)(b) TCGA 1992 or Section 247(3)(b) TCGA 1992 (compulsory acquisition), see CG61920+.

The asset must be acquired "by the taxpayer". The CG Manual provides:

> **26242. Assets acquired by an offshore trust**
> The exclusion from charge, see CG26230, for assets acquired after the taxpayer's departure does not apply to assets acquired within an offshore trust, TCGA 1992, s.86 or TCGA 1992, s.87 or by a non-resident closely controlled company, TCGA 1992, s.13.
> **26243. Example**
> Mr and Mrs Brown, who have lived in the UK all of their lives, leave the UK on 15 November 1999 for Mr Brown to take up a three year contract of employment abroad.
> They resume tax residence in the UK on 1 December 2002.

14 Original erroneously reads 23(4)(b).

Mr Brown had acquired a property in the UK on 4 March 1992. On 12 June 2000, he gave the property to Mrs Brown. Mrs Brown sold the property on 10 March 2001 realising a gain of £100,000.
TCGA 1992, s.58 applies to the gift by Mr Brown, so that for Capital Gains Tax purposes at the time of transfer neither gain nor loss arises. On the sale by Mrs Brown, the gain is treated as accruing in the year of return as she fulfils all of the conditions for TCGA 1992, s.10A to apply, and the asset is not excluded from the charge under TCGA 1992, s.10A(3)(b).

Section 10A(4) TCGA provides:

Where—
(a) any chargeable gain that has accrued or would have accrued on the disposal of any asset ("the first asset") is a gain falling (apart from this section) to be treated by virtue of section 116(10) or (11), 134 or 154(2) or (4) as accruing on the disposal of the whole or any part of another asset, and
(b) the other asset is an asset falling within paras (a) to (d) of subsection (3) above but the first asset is not,
subsection (3) above shall not exclude that gain from the gains which by virtue of subsection (2) above are to be treated as accruing to the taxpayer in the year of return.

The CG Manual provides:

26250. Held-over gains [October 2004]
Gains which have been held-over until the disposal of another asset by virtue of the deferral reliefs listed below, are not to be excluded from the charge under this section by virtue of Section 10A(3) TCGA 1992, where
- the held-over gain accrued on the disposal of an asset acquired while the individual was resident or ordinarily resident in the UK, or
- the asset was connected with the period of residence within the rules in Section 10A(3)(b) TCGA 1992 to Section 10A(3)(d)[15] TCGA 1992, see CG26240.

In the situation where a gain on the disposal of an asset ('the first asset') accrues or would have accrued but is held-over until the disposal of the whole or part of another asset, that second asset will not be excluded by Section 10A(3) TCGA 1992. Any gain released on the first asset will be treated as accruing in the year of return, see CG26111.

15 Original erroneously reads 10A(d).

The Capital Gains Tax deferral reliefs to which this section refers are:

- Section 116(10) TCGA 1992 or Section 116(11) TCGA 1992 (where the new asset is a qualifying corporate bond), see CG53845+.
- Section 134 TCGA 1992 (compensation stock), see CG55045+.
- Section 154(2) or (4) TCGA 1992 (depreciating assets), see CG60370+.

8.10 Section 10A and non-resident trusts/companies

8.10.1 *Losses of non-resident company within s.13 TCGA*

Section 10A provides:

> (2) Subject to the following provisions of this section and section 86A, the taxpayer shall be chargeable to CGT as if— ...
> (c) any losses which by virtue of section 13(8) would have been allowable in his case in any intervening year if he had been resident in the UK throughout that intervening year,
> were gains or, as the case may be, losses accruing to the taxpayer in the year of return. ...
> (6) The reference in subsection (2)(c) above to losses allowable in an individual's case in an intervening year is a reference to only so much of the aggregate of the losses that would have been available in accordance with subsection (8) of section 13 for reducing gains accruing by virtue of that section to that individual in that year as does not exceed the amount of the gains that would have accrued to him in that year if it had been a year throughout which he was resident in the UK.

The CG Manual explains:

> **26201. Losses attributed to participators in non-resident companies**
> Losses on the disposal of an asset by a non-resident company are only available under TCGA 1992, S.13 for set-off by the UK resident taxpayer against gains made by the same company in the same year of assessment or against gains made by other non-resident companies which have been attributed to the taxpayer in the same year of assessment, see CG57250+, in particular, CG57295–CG57299.
> **26202. Losses allowable against gains of same year** [October 2004]
> Gains accruing to a non-resident company in which an individual is a participator are attributable to that individual if he is resident or ordinarily resident. Such gains accruing during a period of temporary non-residence are treated as gains accruing in the year of return.
> Section 10A(6) TCGA 1992 ensures that the provisions of Section 13 TCGA

1992 work as intended by providing that losses of a non-resident company may only be offset against gains of that company, or another non-resident company, which are treated as accruing to the taxpayer **in the same year** of assessment.

26203. Example

Mrs.Adams, who has lived in the UK all of her life, leaves the UK on 1 September 1998 to take up a four year contract of employment abroad.

She resumes tax residence in the UK on 31 August 2002.

Mrs Adams has owned all of the shares in a company resident in Jersey for many years. The company owns a portfolio of shares and a number of properties. During Mrs Adams' period of non-residence the company makes a number of disposals. Gains and losses accrue as follows:

3 May 1999 gain £20,000
23 October 1999 loss £5,000
14 July 2000 loss £10,000
4 September 2001 gain £20,000

Mrs Adams fulfils all of the conditions for Section 10A to apply. Under Section 10A(2)(b) all the gains which would have been treated as accruing to Mrs Adams in the intervening years if she had been resident in those years are treated as accruing to her in the year of return. Losses are allowable to be set against gains of the same year of actual accrual.

Mrs Adams is therefore chargeable in the year of return, 2002-2003 as follows

- net gains of £15,000 (gain £20,000 less loss £5000) for 1999-2000
- a gain of £20,000 for 2001-2002.

The total gains chargeable are therefore £35,000.

The loss arising in 2000-2001 is not allowable.

Careful timing of disposals is necessary to ensure that s.13 company losses are not wasted.

8.10.2 *Temporarily non-resident beneficiaries: s.87 charge*

Section 10A TCGA does not mention s.87 TCGA. So at first sight it might seem that s.87 deemed gains are not caught; but this is not the case. Section 10A(2)(a) TCGA applies to gains accruing to the individual on actual disposals. If a non-resident individual disposes of assets, chargeable gains do accrue to him (even though under s.2 TCGA he is outside the charge to CGT). Subsection (a) likewise applies if an individual receives a capital payment, as trust gains are treated as accruing to the beneficiary under s.87, even if he is non-resident. However, subsection (a) would not catch s.86 or s.13 gains, as gains under these sections do *not* accrue to a non-resident. The sections only apply to a UK resident settlor or participator. Hence the drafter correctly extends s.10A(2) by subsection (b), which applies ss.13 and 86 by deeming the taxpayer to be UK resident. It was not necessary to do this for s.87.

8.10.3 *Temporarily non-resident settlor: s.86 charge*

CG Manual para 26220 provides:

> **Attribution of gains to settlor** [October 2004]
> Section 86 TCGA 1992 provides that in certain cases a UK resident settlor of a non-resident settlement is assessed on the chargeable gains of the trustees, see CG38300. Following the enactment of Section 10A TCGA 1992 a settlor who is temporarily resident outside the UK may also be assessed under Section 86 TCGA 1992 on any gains realised by the trustees during his/her period of non-residence.
> However, all or part of the gains realised by the trustees during the settlor's period of temporary non-residence may already have been charged, under Section 87 TCGA 1992, to beneficiaries of the settlement who have received capital payments, see CG38270. Section 86A TCGA 1992 provides relief in this situation by excluding the gains charged to beneficiaries under Section 87 TCGA 1992 from the extended charge on the settlor under Section 86 TCGA 1992.
> Any case involving Section 86 TCGA 1992 or Section 86A TCGA 1992 is to be reported to Centre for Non-Residents, CNR2 in accordance with CG38223. No attempt to agree or dispute entries in the return should be made until guidance has been received from Centre for Non-Residents, CNR2, see CG38222.

The last sentence tacitly acknowledges that s.86A is a difficult section. The amendments in 2008 have created a fine tangle. I do not attempt to consider the transitional rules here, but only the section as it currently applies. Section 86A(1) TCGA provides:

> (1) Subsection (2) below applies in the case of a person who is a settlor in relation to any settlement ("the relevant settlement") where—
> (a) by virtue of section 10A, amounts falling within section 86(1)(e) for any intervening year or years would (apart from this section) be treated as accruing to the settlor in the year of return; and
> (b) there is an excess of the relevant chargeable amounts for the non-residence period over the amount of the section 87 pool at the end of the year of departure.

"Relevant chargeable amounts" is defined in s.86A(3) TCGA:

> In subsection (1) above, the reference to the relevant chargeable amounts for the non-residence period is (subject to subsection (5) below) a reference to the aggregate of the amounts on which beneficiaries of the relevant settlement are charged to tax under section 87 or 89(2) for the intervening year or years in respect of any capital payments received by them.

"Section 87 pool" is defined in s.86A(4) TCGA:

> In subsection (1) above, the reference to the section 87 pool at the end of the year of departure is (subject to subsection (5) below) a reference to the amount (if any) which, *in accordance with subsection (2) of that section,* fell in relation to the relevant settlement to be carried forward from the year of departure to be included in the amount of the *trust gains* for the year of assessment immediately following the year of departure.

The definition of "s.87 pool" refers back to s.87(2) TCGA. That worked by reference to the original s.87(2) TCGA. Unfortunately s.87 was redrafted in 2008 and by reference to the current s.87(2) the italicised words make no sense. This can easily be seen by comparing the two provisions:

Original s.87(2):

(2) There shall be computed in respect of every year of assessment for which this section applies the amount on which the trustees would have been chargeable to tax under section 2(2) if they had been resident and ordinarily resident in the United Kingdom in the year; and that amount, together with the corresponding amount in respect of any earlier such year so far as not already treated under subsection (4) below or section 89(2) as chargeable gains accruing to beneficiaries under the settlement, is in this section and sections 89 and 90 referred to as the trust gains for the year.

Current s.87(2):

(2) Chargeable gains are treated as accruing in the relevant tax year to a beneficiary of the settlement who has received a capital payment from the trustees in the relevant tax year or any earlier tax year if all or part of the capital payment is matched (under section 87A as it applies for the relevant tax year) with the section 2(2) amount for the relevant tax year or any earlier tax year.

The drafter in 2008 failed to spot that consequential amendments were needed here. Taken literally, therefore, the definition of "section 87 pool" is nonsense and the amount of the s.87 pool should be zero. If one could adopt a position of indifference to statutory words, one might rewite the section to say what Parliament would presumably have said, had the point been noticed, in which case the "section 87 pool" means s.2(2) amounts; though this really amounts to legislation and not construction.

Section 86A(5) deals with settlements with more than one settlor.[16]

Section 86A(6)(7) was intended to deal with the computation of trust gains, now s.2(2) amounts:

> Where any reduction falls to be made by virtue of subsection (2) above in any amount to be attributed in accordance with section 10A to any settlor for any year of assessment, the reduction to be treated as made for that year *in accordance with section 87(3)* in the case of the settlement in question shall not be made until—
> (a) the reduction (if any) falling to be made by virtue of that subsection has been made in the case of every settlor to whom any amount is so attributed; and
> (b) effect has been given to any reduction required to be made under subsection (7) below.

This provision refers to s.87(3) TCGA. That worked by reference to the original s.87(3) TCGA. Unfortunately s.87 was redrafted in 2008 and by reference to the current s.87(3) the italicised words again make no sense. The same problem affects s.86A(7)(8):

> Where in the case of any settlement there is (after the making of any reduction or reductions in accordance with subsection (2) above) any amount or amounts falling in accordance with section 10A to be attributed for any year of assessment to settlors of the settlement, the amount (or aggregate amount) falling in accordance with that section to

16 (5) Where the property comprised in the relevant settlement has at any time included property not originating from the settlor, only so much (if any) of any capital payment or amount carried forward in accordance with section 87(2) as, on a just and reasonable apportionment, is properly referable to property originating from the settlor shall be taken into account for the purposes of subsections (3) and (4) above.

be so attributed shall be applied in reducing the amount carried forward to that year in accordance with section 87(2).
(8) Where an amount has been applied, in accordance with subsection (7)) above, in reducing the amount which in the case of any settlement is carried forward to any year in accordance with section 87(2), that amount (or, as the case may be, so much of it as does not exceed the amount which it is applied in reducing) shall be deducted from the amount used for that year for making the reduction under section 87(3) in the case of that settlement.

Lastly, for completeness, s. 86A(9) provides referential definitions.[17]

8.10.4 *Time limits for assessment*

Section 10A(7) TCGA provides:

> Where this section applies in the case of any individual, nothing in any enactment imposing any limit on the time within which an assessment to capital gains tax may be made shall prevent any such assessment for the year of departure from being made in the taxpayer's case at any time before the end of two years after the 31st January next following the year of return.

The CG Manual provides:

> **26271. Extended time limits** [October 2004]
> Where, however, a gain accrues in the tax year of departure from the UK after the date of the departure, this gain should be assessed by virtue of Section 2 TCGA 1992 in the year of departure. ESC D2 will not apply, see CG26300. In these circumstances to ensure there is sufficient time in which to assess such a gain, the time limit has been specifically extended where the individual satisfies the conditions of Section 10A TCGA 1992 (whether or not gains accrue which are chargeable under that section).
> The extended time limit permits gains accruing in the tax year of

17 Expressions used in this section and section 10A have the same meanings in this section as in that section; and paragraph 8 of Schedule 5 shall apply for the construction of the references in subsection (5) above to property originating from the settlor as it applies for the purposes of that Schedule.

departure from the UK to be assessed at any time up to two years after 31 January next following the year of return to the UK notwithstanding any other time limit for the making of an assessment.
If the conditions of Section 10A TCGA 1992 are not satisfied then the normal assessment time limits will apply.

CHAPTER NINE

THE REMITTANCE BASIS

9.1 Remittance basis – Introduction

Income tax and CGT employ two types or bases of assessment:

(1) An **arising basis** under which tax is charged on the amount of income or gains which arise.
(2) A **remittance basis** under which tax is charged on the amount of income or gains which are received in the UK.

A remittance basis applies (in short) when a foreign domiciliary receives:

(1) Foreign income and gains
(2) Deemed income/gains under various anti-avoidance provisions: the settlement provisions, the TAA provisions and s.87 TCGA.

Before 2008 there were differences between the remittances bases for RFI, employment income and CGT.[1] From 2008/09 there is one common remittance basis for all three, which is also the basis of the remittance basis for the anti-avoidance provisions. I use the following self-explanatory terminology:

(1) "**The ITA remittance basis**" (which applies from 2008/09).
(2) "**The pre-2008 remittance basis**" (which applied until 2008/2009); more specifically, one might refer to"**the pre-2008 RFI, employment income or CGT remittance basis**".

1 It is appropriate that s.761(5) ICTA refers to tax on "*a* remittance basis" rather than *the* remittance basis.

For rates of tax see 34.1 (Rates of income tax).

9.2 Remittance basis – HMRC guidance

HMRC first published the following guidance:
"**FAQ FD (March 2008)**" published 17 March 2008.
"**FAQ Remittances (April 2008)**" published 15 April 2008.
"FAQ: The £30,000 Charge".
"FAQ: Residence and Domicile - NR Trusts".
In assessing this guidance one must bear in mind that the legalisation was only in draft when the guidance was published, and was later amended significantly. This is in any event superceded by later guidance.

Then followed three lengthy sets of questions and answers:
"**December 2008 Qs & As**" published 10 December 2008.[2]
"**January 2009 Qs & As**" published 13 January 2009.[3]
"**March 2009 Qs & As**" published 3 March 2009.[4]

Most of the Qs and As are now superceded by the vast RDR Manual published 31 March 2009. This has three defects which make it difficult to use. First, the RDR Manual generally makes its point by examples which are padded out with many extraneous and irrelevant facts. (No doubt in the spirit of *The Mikado's* Pooh Bah, "intended to give artistic verisimilitude to an otherwise bald narrative".) This is about as unhelpful a method of explaining statutory provisions as could be devised. The consequence is to make it quite unnecessarily difficult to identify the important points from the examples. I sometimes extract the essence of the example so the reader can more easily see the relevant point; then I set the text of the manual in a footnote, so that the reader can see how I do so.

Secondly, the RDR Manual was out of date when published, because it takes no account of the changes (retrospective and prospective) of the FA 2009. Thirdly, the published version has no paragraph numbering, which makes cross-reference difficult. A revised version will no doubt eventually arrive which should deal with the second and third of these defects.

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2 See *www.hmrc.gov.uk/cnr/qa-file.pdf*. In the originals the Qs & As are not numbered but I have added numbers for ease of reference.

3 *www.hmrc.gov.uk/cnr/cgt-qa-jan09.pdf*.

4 *www.hmrc.gov.uk/cnr/qa-file-030309.pdf*.

9.3 "Foreign income and gains"

Section 809Z7 ITA provides:

> (1) This section applies for the purposes of this Chapter.

These are chapter-wide definitions though in accordance with the principles of Plain English drafting, the legislation contains occasional and somewhat unnecessary pointers to the definitions.[5]

> (2) An individual's "foreign income and gains" for a tax year are—
> (a) the individual's relevant foreign earnings for that year,
> (b) the individual's foreign specific employment income for that year,
> (c) the individual's relevant foreign income for that year, and
> (d) if the individual is not domiciled in the UK in that year, the individual's foreign chargeable gains for that year.

9.3.1 *Relevant foreign income*

Section 830(1) ITTOIA provides the definition of "RFI":

> In this Act "relevant foreign income" means income which
> (a) arises from a source outside the UK, and
> (b) is chargeable under any of the provisions specified in subs.(2) (or would be so chargeable if s.832 did not apply to it).

Subsections (2)–(4) set out a list of the categories of RFI, not repeated here. It includes almost all foreign income, including trading income, property income, interest and dividends. This is income formerly taxed under Schedule D Cases IV and V. "Relevant foreign income" is not a helpful label but it is difficult to think of a better one.

A non-resident's income is not RFI as (if it arises from a non-UK source) it is not "chargeable" and does not meet the condition in s.830(1)(b).

5 Eg s.809C(6) ITA: "See s.809Z7 for the meaning of an individual's foreign income and gains for a tax year".

9.3.2 *Relevant foreign earnings ("RFE")*

Section 809Z7(3) ITA provides the definition of RFE:

> An individual's "relevant foreign earnings" for a tax year are—
> (a) if the individual is ordinarily UK resident in that year, the individual's chargeable overseas earnings[6] for that year, and
> (b) otherwise, the individual's general earnings within s.26(1) of ITEPA 2003 for that year (non-UK earnings).

9.3.3 *Foreign specific employment income*

Section 809Z7(4) ITA incorporates the definition from ITEPA:

> An individual's "foreign specific employment income" for a tax year is such of the individual's specific employment income for that year as is are regarded as foreign securities income for the purposes of s.41A of ITEPA 2003.

Foreign specific employment income is not discussed in this book.

9.3.4 *Foreign chargeable gains*

Section 12(4) TCGA provides a commonsense definition:

> In this section "foreign chargeable gains" means chargeable gains accruing from the disposal of an asset which is situated outside the UK.

This is only a section-wide definition, so it has to be repeated or incorporated when the expression is used elsewhere.

Section 809Z7(4) ITA incorporates this definition:

> An individual's "foreign chargeable gains" for a tax year are the individual's foreign chargeable gains (within the meaning of s.12(4) of TCGA 1992) accruing to the individual in that year.

6 Section 809Z7(7) provides: "In subs.(3)(a) 'chargeable overseas earnings' has the same meaning as in s.22 of ITEPA 2003 (see s.23 of that Act)." See 12.3 (Chargeable overseas earnings).

9.3.5 *Capital/income terminology in remittance basis context*

One might start off by thinking that a remittance of income is subject to income tax and a remittance of capital is not. It is not that simple. The terminology of "capital" and "income" in the context of the remittance basis is potentially confusing.

A sum received in the UK may not be taxable under the remittance basis because it is derived not from income but from some fund easily identified as capital in the hands of the taxpayer, such as a gift or inheritance, or borrowing. In cases in this category it makes sense to say that the remittance is tax free because it is one of capital.

A sum received in the UK may not be taxable under the remittance basis because:

(1) the donor was non-resident when the remitted sum accrued; or
(2) the remitted sum has already been subject to income tax.

Such sums might be said to be "income" in the normal sense of the word. These examples show that a remittance of a sum which is income in nature may nevertheless be remittance free of tax under the remittance basis.

(4) Conversely, suppose a remittance basis taxpayer accumulates income offshore for many years; the accumulated fund might be said to be his "capital" in the normal sense of the word. Yet for the purposes of the remittance basis, it is in principle taxable if remitted.[7] Perhaps it is better described as "income".

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7 See (if authority is needed) *Walsh v Randall* 23 TC 55:
"... the accumulated income which he had derived from the drawings of the firm of which he was a sleeping partner. I have no doubt that he had come to regard this sum of money as capital. It was invested savings and it was in that sense capital, unless it can be said that, for instance, a professional man's invested savings never are and never become capital. I should have thought it was quite a harmless thing to use the word 'capital' in relation to a professional man, or indeed to any other private person. I think that word may very definitely have a meaning with regard to ordinary private persons and may be correctly used to describe some part of their property. That, however, is not, for Income Tax purposes, the test. To the Crown the [unremitted] income of a person residing in the UK is, as I gather, always income until it is taxed."

It is best not to use the terminology of capital/income in cases (1) to (4): it is unnecessary to do so.

9.4 History of the remittance basis

It is not necessary for a practitioner to know the history of the remittance basis but it makes an interesting story and is helpful to understand the background to the older cases.[8]

Until 1914 all foreign income was taxed on a remittance basis: s.100 Income Tax Act 1842. Since then the remittance basis has been withdrawn, in stages, except for foreign domiciliaries. In 1914 income from "securities, stocks, shares, or rents in any place out of the UK" was brought onto an arising basis: s.5 FA 1914. This did not apply to foreign domiciliaries and non-ordinarily resident British subjects. Even those who were domiciled and ordinarily resident in the UK retained the remittance basis for any foreign source income which did not consist of securities or rents. Hence the need for cases to decide whether trust income was to be regarded as income arising from securities or from the trust.[9] In 1940 the general remittance basis was further restricted, to (a) income from offshore trades, professions or vocations, and (b) income from offshore offices, employments or pensions: s.19 FA 1940. The exception was intended, perhaps, to encourage foreign trade. However, it did enable tax planning by splitting a single mixed UK and foreign based trade into separate UK and foreign source trades, the latter qualifying for the remittance basis. An arrangement of this kind was held to be successful in *Newstead v Frost* 53 TC 525. So in 1974 this was abolished: ss.22, 23 FA 1974.

The same rules applied to companies as to individuals, until the introduction of corporation tax in 1965, which put UK resident companies onto an arising basis.

In 2008 the remittance basis was recast, and restricted by the remittance basis claim charge.

8 See "Taxing Foreign Income from Pitt to the Tax Law Rewrite—The Decline of the Remittance Basis", John Avery Jones in *Studies in the History of Tax Law*, Hart Publishing, 2004 accessible on *www.kessler.co.uk*.

9 See 11.15 (Income from interest in possession type trusts: identifying the source).

9.5 Who qualifies for the remittance basis?

After a (somewhat unnecessary) overview in accordance with the principles of plain English drafting,[10] s.809B, 809D and 809E ITA set out four categories of individuals to whom the remittance basis applies:

(1) Section 809B is the main category, those who make a claim for the remittance basis. I refer to these as "**remittance basis claimants**".

The other three categories are classes of *de minimis* taxpayers, defined with complex and pernickety detail, retrospectively introduced by the FA 2009.

(2) Section 809D applies to:
  (a) individuals whose unremitted foreign income and gains are less than £2,000. I refer to these as "**sub-£2k remittance basis taxpayers**".
  (b) employees with small amounts of foreign employment income. I refer to these as "**lower paid employees**".

(3) Section 809E applies to those with no (or virtually no) UK source income and gains who do not remit any foreign income or gains. I refer to these as "**non-taxpayers**".

The advantage of being in one of the three de minimis categories is that the remittance basis claim charge does not apply, personal allowances remain available, and the individual is not forced to make a CGT loss election.

I refer to the four groups together as "**remittance basis taxpayers**". HMRC use the term "remittance basis user". (Since about 2001, HMRC do not like to use the word "taxpayer".)

9.6 Remittance basis claimants: s.809B

Section 809B ITA provides:

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10 Section 809A ITA provides: "This Chapter provides for an alternative basis for charge in the case of individuals who are not domiciled in the UK or are not ordinarily UK resident".

> (1) This section applies to an individual for a tax year if the individual-
> (a) is UK resident in that year,
> (b) is not domiciled in the UK in that year or is not ordinarily UK resident in that year, and
> (c) makes a claim under this section for that year.
> (2) The claim must contain one or both of the following statements-
> (a) that the individual is not domiciled in the UK in that year;
> (b) that the individual is not ordinarily UK resident in that year.

Thus two categories of individual may claim the remittance basis:

(1) A UK resident foreign domiciliary.
(2) A person who is:
  (a) resident but not ordinarily resident in the UK; and
  (b) domiciled in the UK (or he would fall within the first category anyway).

Category (2) must be a rare case. HMRC agree. The RDR Manual provides:

> Most long-term UK Residents will also be Ordinarily Resident in the UK, so most, although not necessarily all, individuals who pay the remittance basis charge will use the remittance basis on account of their non-dom status. Cases involving individuals who are UK-domiciled but claim to be NOR and who pay the remittance basis charge should be referred to CAR Residency for a review of their NOR status claim.

Category (2) does not qualify for the CGT remittance basis. It is suggested that the law could be simplified, and the anomaly fairly corrected, by abolishing this category and bringing such persons on to the arising basis. However the 2008 reforms chose not to do this, so the anomaly is likely to remain for the foreseeable future. For simplicity I will on most occasions ignore this possibility and simply refer to “foreign domicile”.

The claim is made by ticking the relevant box in the tax return.[11] Section 809B(3) ITA provides:

11 Box 27 supplemental pages form SA109 (Residence remittance basis, etc) in the 2008/09 form.

> Sections 42 and 43 of TMA 1970 (procedure and time limit for making claims), except s.42(1A) of that Act, apply in relation to a claim under this section as they apply in relation to a claim for relief.

Thus the usual time limits apply.

The RDR Manual provides:

> If the return is subsequently amended, the claim may be included then or a previously made claim may be amended or deleted (TMA70/s42(5)). However when the time period for making an amendment has passed, the claim may not be withdrawn even if the making of the claim turns out to have been an error. This is because error or mistake relief does not apply to claims made to use the remittance basis under ITA07/s809B (TMA70/s33(2A)(c)).

It is possible to claim the remittance basis in one year and not in another year, thus opting in and out of the remittance basis.

HMRC Business Brief 17/09 provides:

> The rules for nominating income and gains upon which the £30,000 is paid, and the rules for identifying what is taxed if those nominated income or gains are later remitted to the UK, can be complex. To help ensure individuals who pay the £30,000 get the right level of customer support from HMRC, we have decided that most individuals who pay the £30,000, or have paid it in the past, will have their tax affairs dealt with in one HMRC office from 2009-10. This will be the CAR Residency office in Castle Meadow, Nottingham.
>
> Customers who are sent a self assessment return by a different office should make the return to the office issuing that return. Once the return has been received by HMRC we will arrange for the individual's tax records to be transferred to the CAR Residency office in Nottingham and advise the individual and any agent, accordingly. Until such time as individuals or their agents receive such a notification they should continue to deal with their current tax office.

9.7 Sub-£2k remittance basis taxpayer: s.809D

Section 809D ITA was amended with retrospective effect in the FA 2009. It now provides:

> (1) This section applies to an individual for a tax year if-

(a) the individual is UK resident in that year,
(b) the individual is not domiciled in the UK in that year or is not ordinarily UK resident in that year, and
(c) the individual's unremitted[12] foreign income and gains for that year are less than £2,000.

unless condition A or condition B is met.
(1A) Condition A is that the individual is not domiciled in the UK in that year and conditions A to F in section 828B are met.[13]
(1B) Condition B is that the individual gives notice in a return under section 8 of TMA 1970 that this section is not to apply in relation to the individual for that year.

Why should anyone wish to make a claim under s.809D(1B) and move from being a sub-£2k remittance basis taxpayer to the arising basis? The reason may be that the remittance basis (for those without very large incomes) involves simply too much trouble and expense to operate: it is more cost effective to pay tax on an arising basis. Another reason might be to facilitate double taxation relief.

9.7.1 *Interaction of £2k limit with split-year concessions*

The RDR Manual provides:

> ESC A11 may apply to an individual for the year in which they arrive or leave the UK; it effectively splits the tax year into periods of residence and non-residence and computes liability accordingly. This generally means that foreign income from the period of "non-residence" is not subject to UK tax.
> However in considering whether the "below £2,000 threshold" limit applies in respect of use of the remittance basis of taxation under ITA07/s809D, the level of unremitted foreign income and gains for the entire tax year must be taken into account.

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12 Section 809D(2) provides a commonsense definition of "unremitted":

> "An individual's 'unremitted' foreign income and gains for a tax year are so much of the individual's foreign income and gains for that year as are not remitted to the UK in that year."

13 This relates to lower-paid employees see 12.20 (Lower-paid employee exemption). I do not understand the reason for condition A.

This is straightforward but the Manual gives an example to drive the point home:[14]

> F enters the UK on 20 October 2010, and is resident for the tax year 2010-11. He claims[15] split-year treatment under ESC A11.
> F's foreign income is as follows:
> 6 April to 19 October 2010 £2,200.
> 20 October 2010 to 5 April 2011 £1,300.
> F remits £1,000 to the UK in that year.
> At the end of the year his total unremitted foreign income is £2,500.

The HMRC analysis is as follows:

> Even though F has claimed split-year treatment for 2010-11, he still has to include any foreign income that arose before he entered the UK.
> As F's unremitted foreign income is above the £2k threshold he cannot use the remittance basis under s809D. If he wishes to use the remittance basis he will need to claim under ITA07/s809B, and will lose his personal allowances and the annual exempt amount.

In practice, F (if well advised) would not make a claim for the remittance basis but he could save a few pounds of tax by remitting £1,500.01 to the UK indeed of £1,000.

The same applies for chargeable gains under ESC D2. But in practice it hardly matters.

9.8 Non-taxpayers: s.809E

Section 809E(1) ITA was amended with retrospective effect in the FA 2009. It now provides:

> This section applies to an individual for a tax year if—
> (a) the individual is UK resident in that year,
> (b) the individual is not domiciled in the UK in that year or is not ordinarily UK resident in that year,

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14 I have slightly altered the wording of the example for enhanced clarity.

15 *Sic*. It would be more accurate to say "qualifies for split-year treatment" since the concessions do not need a claim. But nothing turns on that.

(c) for that year the individual either has no UK income or gains[16] or has no UK income and gains other than taxed investment income not exceeding £100.
(d) no relevant income or gains are remitted to the UK in that year, and
(e) either—
    (i) the individual has been UK resident in not more than 6 of the 9 tax years immediately preceding that year, or
    (ii) the individual is under 18 throughout that year.

unless the individual gives notice in a return under s.8 of TMA 1970 that this section is not to apply in relation to the individual for that year.

Thus there are five requirements which must all be met. Requirements (a), (b) and (e) do not need comment.

9.8.1 *(Virtually) no UK income/gains*

The requirement in s.809E(1)(c) is:

> (c) for that year the individual either has no UK income or gains or has no UK income and gains other than taxed investment income not exceeding £100.

Section 809E(2) ITA provides a commonsense definition:

> For the purposes of subs.(1)(c) the individual's "UK income and gains" for the tax year are the individual's income and chargeable gains for that year other than what would (if this section applied) be the individual's foreign income and gains for that year.

The FA 2009 introduced the paltry exemption for £100 "taxed investment income". This term is defined in s.809E(2A) ITA:

> For the purposes of subsection (1)(c) "taxed investment income" means UK income or gains consisting of payments within s.946 from which a

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16 Section 809E(2) ITA provides a commonsense definition:
"For the purposes of subs.(1)(c) the individual's 'UK income and gains' for the tax year are the individual's income and chargeable gains for that year other than what would (if this section applied) be the individual's foreign income and gains for that year."

sum representing income tax has been deducted.

9.8.2 *No relevant income or gains remitted*

The requirement in s.809E(1)(d) is:

> (d) no relevant income or gains are remitted to the UK in that year, and

Section 809E(3) ITA provides the definition:

> For the purposes of subs.(1)(d) "relevant" income and gains are—
> (a) what would (if this section applied) be the individual's foreign income and gains for the tax year mentioned in subs.(1), and
> (b) the individual's foreign income and gains for every other tax year for which s.809B or 809D or this section applies to the individual.

Para 85 Sch 7 FA 2008 contains transitional provisions for pre-2008 income and gains:

> (1) In s.809E(3)(b) of ITA 2007, the reference to a tax year for which s.809B, 809D or 809E of that Act applies to an individual includes a tax year (not later than the tax year 2007-08) in which the individual—
> (a) was UK resident, but
> (b) was not domiciled in the UK or was not ordinarily UK resident.
> (2) In relation to such a tax year, the reference there to the individual's foreign income and gains includes the individual's relevant foreign income if (and only if)—
> (a) the individual made a claim under s.831 of ITTOIA 2005 for the year, or
> (b) s.65(5) of ICTA (or any earlier superseded enactment corresponding to that provision) applied in relation to the individual for the year.

9.8.3 *Procedure*

BN55 (22 April 2009) provides:

> There is a new box on the supplementary "Residence and Remittance Basis etc." pages (SA109) for such individuals to advise HMRC of their use of the remittance basis under section 809D. This ensures they

> continue to get their Personal Allowances and the Annual Exempt Amount.

This is box 28 in the 2008/09 form.

9.8.4 *Concession for remittances by sub-£2k taxpayer*

BN55 (22 April 2009) provides:

> **Remittance basis users whose foreign income and gains is less than £2,000**
> Individuals making use of section 809D are still taxable on any foreign income or gains remitted to the UK. ...
> It is recognised that some individuals, in particular those on low income, may make small cash remittances to the UK, out of foreign income or gains, and as a result have to complete a Self Assessment tax return possibly to pay only a small amount of tax. This is particularly the case where foreign tax has already been paid on the income or gains. Where an individual who is making use of section 809D remits less than a total of £500 in cash, which arises from foreign income or gains, into the UK during the tax year, then HMRC will accept that such an individual does not need to make a Self Assessment Tax return simply to pay the tax on those cash remittances. However where such an individual is required to complete a Self Assessment tax return for any other reason, or HMRC serves them with a notice to make a return, then they will need to include those remittances on the return and pay the tax due. This practice will apply for 2008-09 and subsequent years.

This is a concession (the word concession is not used, presumably because HMRC are not now supposed to issue concessions). A concession which only applies if HMRC chose not to require a SA return is a new development in tax, and setting the limit at £500 is difficult to defend, but the manner of introduction of the concession meant that there could be no debate on it.

9.8.5 *What is the purpose of s.809E?*

EN FB 2008 provides:

> Individuals entitled to claim the remittance basis who have no UK

income or gains, and who don't remit any foreign income or gains, won't have to claim the remittance basis in years they are not liable to the RBC. This avoids them having to complete a self assessment return only so they can claim the remittance basis and then have no tax to pay.

There will not be many non-taxpayers within s.809E – mainly spouses accompanying their partners, children and some students, perhaps.

9.9 IP trusts

In IP trusts, the taxation of the trustees is affected by the status of the life tenant. TSE Manual provides:

> **3160. Resident trustees with trust income from abroad: beneficiary is not resident** [April 2007]
> These instructions apply only if the beneficiary has an absolute interest in trust income (TSEM6204). This includes a life tenant and an annuitant.
> The trustees' income tax liability is based on the beneficiary's residence position. Trustees are not chargeable in respect of the share of income from abroad payable to the non-resident beneficiary. They exclude it from the Trust and Estate Tax Return. [See] *Williams v Singer* 7 TC 387
> **3165. Resident trustees with trust income from abroad: beneficiary is resident but not domiciled**
> These instructions apply only if the beneficiary has an absolute interest in trust income (TSEM6204). This includes a life tenant and an annuitant.
> The trustees' income tax liability is based on the beneficiary's domicile. Their liability on the share of income from abroad (apart from the Republic of Ireland) payable to the non-resident beneficiary is limited to the amount remitted to the UK. Trustees exclude from the Trust and Estate Tax Return any such overseas income that is not remitted to the UK.
> Income from the Republic of Ireland is assessable on the amount arising. The remittance basis does not apply. [See] *Williams v Singer* 7 TC 387
> **3170. Resident trustees with trust income from abroad – beneficiary is resident but not ordinarily resident**
> These instructions apply only if the beneficiary:

- has an absolute interest in trust income (TSEM6204). This includes a life tenant and an annuitant;[17]
- Is a citizen of the Commonwealth or the Republic of Ireland.

The trustees' income tax liability is based on the beneficiary's not ordinarily resident status. Their liability on the share of other income from abroad (apart from the Republic of Ireland) payable to the non-resident beneficiary is limited to the amount remitted to the UK. Trustees exclude from the Trust and Estate Tax Return any such overseas income that is not remitted to the UK.
Income from the Republic of Ireland is assessable on the amount arising. The remittance basis does not apply. [See] *Williams v Singer* 7 TC 387

No thought has been given to the position from 2008. It is considered that the general principles behind the statement are still valid, though from 2008/09 trustees could only qualify for the remittance basis if the life tenant claimed it (and they may not be aware whether a claim is made), and the references to Ireland are out of date.[18]

9.10 Time of foreign domicile

Section 809B(1) ITA requires (in short) that the foreign domiciliary is not domiciled in the UK in the year that the income arises.

It is an interesting question what is the position if a person changes domicile during a year. The 2008 reforms declined the opportunity to address the question, perhaps because that would have required a consideration of the unsatisfactory ESC A11, raising too many difficult questions.

9.11 Effect of remittance basis claim on allowances

Section 809G ITA disapplies IT personal allowances for remittance basis claimants:

> (1) This section applies if s.809B (claim for remittance basis to apply) applies to an individual for a tax year.
> (2) For that year, the individual is not entitled to-

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17 The Manual adds "is a citizen of the Commonwealth or the Republic of Ireland". However, this condition does not apply from 2005/06.

18 See 9.23 (Income from Ireland).

(a) any allowance under Chapter 2 of Part 3 (personal allowance and blind person's allowance),
(b) any tax reduction under Chapter 3 of that Part (tax reductions for married couples and civil partners), or
(c) any relief under s.457, 458 or 459 (payments for life insurance etc).

This does not apply to remittance basis taxpayers in the three de minimis categories: they retain their allowances.

The editor of *Taxation* comments acerbically on s.809G(2)(c):

> So what are these valuable reliefs which it would be unfair to allow those claiming the remittance basis to enjoy? They are relief from tax on half of the premiums paid to trade unions and police organisations for superannuation, life insurance or funeral benefits, or to the employer so that benefits can be paid after the employee's death to their dependants, but limited to £100 a year of relief in each case.
> What on earth is the point of removing a relief like that for the non-domiciles? It is pointless complexity for the sake of a few tenners in tax which will have no impact whatsoever on the non-domiciles concerned. Unless there is some issue related to European law, or human rights (which seem to be the normal culprits in these situations) I really cannot see why the parliamentary draftsman should have been troubled with the need to include them. And, frankly, if there is some such problem, then given the minuscule levels of relief they offer even to those not on the remittance basis, wouldn't it be simpler to just abolish the sections altogether? That would at least be simplification.[19]

Likewise s.3 TCGA[20] disapplies the CGT annual exemption:

> (1) An individual shall not be chargeable to capital gains tax in respect of so much of his taxable amount for any year of assessment as does not exceed the exempt amount for the year.
> (1A) Subs.(1) does not apply to an individual for a tax year if s.809B of ITA 2007 (claim for remittance basis to apply) applies to the individual for that year.

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19 *Taxation* 21 Feb 2008 p.161 (Mike Truman).
20 Flagged (somewhat unnecessarily) in s.809G(3) ITA.

This applies even to a person who is UK domiciled but not ordinarily resident, even though such a person pays CGT on an arising basis.

9.12 Treaty defence to disallowance of reliefs

The allowances which are disapplied for remittance basis claimants may be restored under a DTT. For instance, Article 16(2) of the UK/Ireland DTT provides:

> Individuals who are residents of the Republic of Ireland shall be entitled to the same personal allowances, reliefs and reductions for the purposes of UK tax as British subjects not resident in the UK.

Treaties with wording of this kind override the disapplication of personal allowances.[21] The treaties with such wording are: Austria, Belgium, Fiji, Germany, Ireland, Kenya, Luxembourg, Mauritius, Namibia, Netherlands, Portugal, Swaziland, Sweden, Switzerland and Zambia.[22] The OECD Model Convention does not include this provision; it is found only in older DTTs and their number will diminish over time.

This treaty relief is applicable only where:

(1) the individual is UK resident (or the restriction on allowances cannot apply); and
(2) the individual is treaty-resident in the jurisdiction concerned, under the relevant tie-breaker clause.

So the point will not be a common one, though it will arise from time to time.

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21 Jane Kennedy (Financial Secretary to the Treasury) accepted this in the public Bill committee debate on the Finance Bill, Hansard 19 June 2008 col 818, accessible *www.publications.parliament.uk/pa/cm200708/cmpublic/finance/080619/am/80619s05.htm*. The same point is made in Q8 January 2009 Qs & As.

22 The DTTs with Burma and Greece also grant personal allowances, but these treaties do not confer relief on dual residents so they do not help here. France was formerly in the list but the UK/France treaty signed on 19 June 2008 does not include this clause.

9.13 Remittance basis claim charge

9.13.1 *"Long-term UK resident"*

Section 809H ITA provides:

> **809H Claim for remittance basis by long-term UK resident: charge**
> (1) This section applies if—
> (a) s.809B (claim for remittance basis to apply) applies to an individual for a tax year ("the relevant tax year"),
> (b) the individual is aged 18 or over in the relevant tax year, and
> (c) the individual has been UK resident in at least 7 of the 9 tax years immediately preceding the relevant tax year.

I adopt the statutory terminology and refer to individuals to whom s.809H(1)(c) applies as "**long-term residents**".

The period of residence might be continuous or broken.

While a person is under 18:

(1) he is not subject to the £30k charge; but
(2) any UK resident years do count in determining his status as a long-term resident.

The RDR Manual provides:

> *Interaction with Extra Statutory Concession (ESC) A11*
> ... Even if this "split-year" treatment is given, years [of arrival and departure] will count as a full year of residence in determining whether an individual meets the long-term residents rule, that is, whether he has been in the UK for at least 7 out of the 9 tax years immediately preceding the current tax year.

9.13.2 *Nomination of income and gains*

Section 809C ITA provides:

> **809C Claim for remittance basis by long-term UK resident: nomination of foreign income and gains to which s.809H(2) is to apply**
> (1) This section applies to an individual for a tax year if the individual-
> (a) is aged 18 or over in that year, and
> (b) has been UK resident in at least 7 of the 9 tax years immediately

> preceding that year.
> (2) A claim under s.809B by the individual for that year must contain a nomination of the income or chargeable gains of the individual for that year to which s.809H(2) is to apply.

Following the statutory terminology,[23] I refer to the income or gains so nominated as "**nominated income/gains**". Section 809C continues:

> (3) The income or chargeable gains nominated must be part (or all) of the individual's foreign income and gains for that year.
> (4) The income and chargeable gains nominated must be such that the relevant tax increase does not exceed £30,000.

Section 809C(5) ITA provides a commonsense definition of "the relevant tax increase":

> "The relevant tax increase" is-
> (a) the total amount of income tax and capital gains tax payable by the individual for that year, minus
> (b) the total amount of income tax and capital gains tax that would be payable by the individual for that year apart from s.809H(2).

EN Amendments to the Remittance Basis Charge explains the reason for the £30k cap in s.809C(4):

> This stops an individual from nominating too much income and gains and as a result paying a remittance basis charge of more than £30,000.

The legislation does not say what happens if an individual fails to nominate any income/gains or if he nominates income/gains but the relevant tax increase exceeds £30k. The RDR Manual states:

> Any claim that does not include a nominated amount is not valid.
> ...

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23 Section 809H(3) ITA provides: "'Nominated' income or chargeable gains means income or chargeable gains nominated under s.809C in the individual's claim under s.809C for the relevant tax year." The definition is repeated in s.809I(3) and s.809J(3) ITA. (If a chapter-wide definition had been used the repetition would have been unnecessary.)

The remittance basis charge cannot exceed £30,000. Any nominations which produce an excessive relevant tax increase may invalidate the claim under section 809B to be taxed on the remittance basis.
If this occurs you should try to contact the taxpayer, or their agent to advise them of their excessive nomination and to assist them to amend their claim to ensure it is valid. To do that the amount of nominated income or gains must be adjusted so that the relevant tax increase equals £30,000.

The following example from the RDR Manual shows how complicated this will be:

Relevant tax increase: Example 2
Lorna, a non domiciled long-term UK resident makes a claim to use the remittance basis in 201X and must pay the £30,000 remittance basis charge (RBC). She is a higher rate taxpayer (40%), with UK source employment income of £80,000.
She also has £150,000 of interest (relevant foreign income) from an overseas investment in Country X paid to her.
Because nominated income is taxed on the "arising basis", a remittance basis user is in the same position as any other UK resident person and is, subject to the ordinary rules that apply in such cases (ICTA88/s793+), entitled to credit against UK tax for certain amounts of overseas tax that is payable on that same income.
Under the domestic law of Country X in which the investment was made, the interest was paid after deduction of 15% withholding tax. The Double Taxation Agreement between the UK and Country X provides that tax on this interest may be retained in the "source" country at the rate of 15%.
Lorna is therefore entitled to a credit, which she takes in the form of foreign tax credit relief (FTCR), against UK tax for the tax withheld in the other country. ...
Foreign tax credit relief calculation – general principles
Ignoring the remittance basis issue for the moment:
Lorna has received foreign interest of £150,000, on which Country X's foreign tax of £22,500 has been deducted.
Lorna's income is chargeable to tax at 40%. The UK tax charge is respect of this £150,000 would be £60,000 (40% x £150,000).
If she claims foreign tax credit relief her net liability to UK tax after the foreign tax credit relief will be:
£60,000 minus £22,500 = £37,500
Relevant tax increase including FTCR
Foreign tax credit relief is only due to the extent that the foreign income on which it is given is brought into the UK tax charge. So for remittance basis users, relief for foreign tax paid on foreign income chargeable on the remittance basis is given when that income is remitted.
However for remittance basis charge payers like Lorna, any foreign income which she nominates is chargeable on the arising basis so foreign tax credit relief

can be given in relation to that that nominated income.

Because the "relevant tax increase" must be £30,000, Lorna will need to nominate £120,000 of her foreign interest if she wishes to create an overall remittance basis charge of £30,000.

- FTCR calculation

Foreign tax that relates to the £120,000 nominated (at 15%)	£18,000
UK tax on £120,000 (at 40%)	£48,000
Net liability to UK tax after the FTCR (£48,000 minus £18,000)	£30,000 (see note 2 below)

- Relevant tax increase calculation

To determine the relevant tax increase we must complete two calculations. The first calculation (a) is of the total amount of Lorna's income tax and capital gains tax actually payable in the year, as a remittance basis user and RBC payer. The second calculation (b) is the total amount of Lorna's income tax and capital gains tax that would be payable by Lorna in the year as a remittance basis user, but if there was no nomination required and no RBC due, that is, if there was no income tax or CGT due on [her] nominated foreign income or gains.

The relevant tax increase is the total of calculation (a) minus calculation (b)

	Calculation (a)			Calculation (b)		
Non-savings income						
20%[1] on	**£34,800**	=	**£6,960**	**£34,800**	=	**£6,960**
40% on	**£45,200**	=	**£18,080**	**£45,200**	=	**£18,080**
	£80,000		£25,040	£80,000		£25,040
Savings						
40% on	£120,000[2]	=	**£30,000**	Note 4		
Total Income Tax Due			**£55,040**[3]			**£25,040**[4]

1 Rates and thresholds used here for the purposes of this example only; use the rates applying in the relevant tax year.

2 This is the foreign income that is nominated, and charged to tax on the arising basis in the year. FTCR is given, which has reduced the tax to £30,000.

3 As a remittance basis user, Lorna has no personal allowances due.

4 Lorna is a remittance basis user so would not be subject to tax on her unremitted foreign income, nor would any FTCR be due.

Relevant Tax Increase is	Total (a)	£55,040
less	Total (b)	£25,040
		£30,000

March 2009 Qs & As provides:

Q3: HM Revenue & Customs (HMRC) have indicated that individuals do not have to specify which account the nominated income comes from, and from this it could be inferred that without further disclosure of the particulars of the account the taxpayer may be at risk of "tainting" every other source of income of that type. For example if an individual has an account with one bank in Jersey and another bank in a different jurisdiction, he could nominate bank interest on his Jersey account, so that it would be obvious that if he remitted income from his other account, he might not fall foul of re-characterisation provisions. However, this may not be the case if he had three different accounts with the same bank in Jersey and he wishes to nominate income from one of those accounts without disclosing the account number of that account. Can HMRC clarify what their approach to this will be?

A: It is up to the individual to decide how much information to give HMRC on their Self Assessment returns in order to identify the source of the nominated income or gains; if, as in this example, there is more than one account the individual should provide sufficient detail to distinguish between them and identify the "nominated" account. That might be the entire account number, or the account "name", or some other unique identifying feature of the account.

The RDR Manual provides:

Completing the SA Return - How is this done in practice?

SA109 "Residence, remittance basis etc" is the supplementary page to the SA100 main tax return for remittance basis users to complete under Self Assessment.

There is a box to claim the remittance basis on the SA109 and two boxes where the "amount of nominated income" and the "amount of nominated capital gains" must be entered. The amount nominated can be either income or gains or a combination of the two. The source(s) of the amount nominated is the individual's personal choice.

When either or both of these boxes are completed the SA109 notes say that details of the nominations are to be shown in the "Any other information" box.

The required information is:

- the precise amounts of income and gains that have been nominated, (this should include the country of origin and the type and source of the income)
- the computation of the gain (if applicable)
- the exchange rates used
- the calculation of the tax due in relation to the nominated income and gains.

Also if there have been deductions for expenses or losses from either foreign income or foreign gains in arriving at the final taxable amount,

> full details of the amounts and nature of those expenses or losses must also be provided.
> All of this information is required to validate the nomination or nominations that have been made.

9.13.3 *Nominated income/gains charge*

Section 809H(2) ITA provides:

> Income tax is charged on nominated income, and capital gains tax is charged on nominated chargeable gains, as if s.809B did not apply to the individual for the relevant tax year (and neither did s.809D).

This disapplies the remittance basis, so nominated income and gains are taxed on the arising basis. I refer to this as the "**nominated income/gains charge**".

EN FB 2008 provides:

> 14. This charge is in addition to the tax liability for the year in question on any income and gains remitted to the UK, and any UK income or gains taxed on the arising basis. The £30,000 will be paid on nominated income and gains not remitted to the UK in the year. (These income and gains are called "nominated" income and gains because the taxpayer is free to nominate the income and gains not remitted to the UK in the year on which tax of £30,000 is payable. For example, this could be £75,000 of unremitted foreign deposit interest on which UK tax was due at 40 per cent, so leading to an income tax charge of £30,000.)

9.13.4 *Remittance basis deficit charge*

The removal of the remittance basis for nominated income/gains might not yield the desired additional £30k tax for various reasons. The individual might under-nominate i.e. he might not nominate enough income/gains. There is no requirement to nominate enough to give rise to a £30k IT or CGT charge. Indeed, it is not always possible to know how much that would be. One could nominate just £1, as long as what is nominated is foreign income or gains. HMRC agree. The RDR Manual provides:

> *Insufficient nomination*
> Although an individual may choose to make an <u>insufficient nomination</u>

> they must have foreign income and/or foreign chargeable gains from the tax year such that, they can nominate something, even if only £1. This fulfils the mandatory requirement that a nomination **must** be made when making the claim.
>
> *Completing the self-assessment return*
>
> All claims and nominations are made on the individual's self assessment tax return. The minimum amount that can be nominated **must** be at least £1 of foreign income or gains for the claim to be valid. Where a claim to the remittance basis is made under s809B but no nomination of either foreign income or capital gains is made the claim is invalid.[24]

According to EN Amendments to the Remittance Basis Charge this was done to enhance confidentiality:

> 7. The legislation provides the option for those who can claim the remittance basis not to disclose anything about their unremitted income or gains as they can make a claim with a nominal £1 amount and do not have to specify what further foreign income or gains remain unremitted.

But it would not be in the interests of the taxpayer to under-nominate, and the confidentiality is illusory because HMRC are likely to make further enquiries.

(2) The individual may have reliefs (e.g. loss relief, interest relief, DTRs, etc).

Section 809H(4) ITA goes on to ensure that HMRC will receive their desired £30k tax:

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24 Similarly March 2009 Qs & As provides:

> "**Q7:** The question has arisen whether less than £1 (ie pence) can be nominated income. Given current interest rates there is concern that accounts specifically set up to generate nominated income may not generate £1 before 6 April 2009. The concern expressed is that because pence are rounded down on tax returns, it might be your view that there is no nominated income?
>
> **A:** The minimum nomination of income or gains required to calculate the relevant tax increase is £1. This is the minimum figure to be declared on the relevant supplementary page of the Tax Return."

But where is the statutory authority for HMRC to disregard figures under £1?

> If the relevant tax increase would otherwise be less than £30,000, subsection (2) has effect as if—
> (a) in addition to the income and gains actually nominated under s.809C in the individual's claim under s.809B for the relevant tax year, an amount of income had been nominated so as to make the relevant tax increase[25] equal to £30,000, and
> (b) the individual's income for that year were such that such a nomination could have been made (if that is not the case).

I refer to s.809H(4) as the "**£30k deficit charge**". The £30k deficit charge is a tax on deemed income (deemed nominated income) and not on any actual income of the taxpayer (if indeed the taxpayer has other income). Section 809H(6) ITA makes this clear (if necessary):

> Nothing in subs.(4) affects what is regarded, for the purposes of s.809I or 809J, as nominated under s.809C.

I use the term "**remittance basis claim charge**" to mean the two distinct (albeit related) charges:

(1) the nominated income/gains charge, under s.809H(2); and
(2) the deficit charge, under s.809H(4).

It might be more accurate to refer to remittance basis claim *charges* (in the plural). However for many purposes it does not matter that there may be two charges rather than one, (especially since in practice the second will not often arise) and it is convenient to have one label for them both.

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25 Section 809H(5)(5A) ITA repeats the definition of "the relevant tax increase" from s.809C(5) (5A):
"'The relevant tax increase' is—
(a) the total amount of income tax and capital gains tax payable by the individual for the relevant tax year, minus
(b) the total amount of income tax and capital gains tax that would be payable by the individual for the relevant tax year apart from subsection (2).
(5A) The references to income tax in subsection (5) do not include income tax under s.424 (gift aid)."
If there had been a chapter-wide definition the repetition would have been unnecessary.

9.13.5 *Administration*

FAQ: The £30,000 Charge provides:

> **How will the £30,000 charge be collected?**
> The collection of the £30,000 charge will be administered through the SA tax return system. So any individual wishing to claim the remittance basis once they have been in the UK for more than seven out of the previous ten years will need to file an SA tax return and pay the £30,000 charge.
> **Will the £30,000 be collected through PAYE?**
> No. The collection of the £30,000 charge will be administered through the SA tax return system. So any individual wishing to claim the remittance basis once they have been in the UK for more than seven out of the previous ten years will need to file an SA tax return and pay the £30,000 charge.

Of course the claim charge could not be collected through PAYE. For one thing, the charge might be a charge to CGT and even if it is income tax it need not be a charge on employment income. Also the claim on which the charge depends will be made in the tax return some time after PAYE is due.

EN FB 2008 provides:

> 17. As the RBC consists of income tax or CGT paid on the arising basis, the normal rules for payment dates, including payments on account, and for Gift Aid apply.

9.13.6 *Interaction with payments of IT on account*

The RDR Manual provides:

> **Payments on account - Interaction with the remittance basis charge (RBC)**
> The remittance basis charge may consist of either income tax or capital gains tax, or a mixture of the two ...
> To the extent that the remittance basis charge consists of income tax, the payment on account position for those paying the charge is the same as that for any other SA taxpayer. This means their payments on account are based their income tax liability for the previous year (TMA1970/s59A(1)).
> The relevant SA109 "*Residence, remittance basis etc*" supplementary pages to the SA tax return must be completed to both claim the remittance basis and nominate income or gains and pay the remittance basis charge.

Effect and treatment of income

If paying part or all of the remittance basis charge in respect of nominated income, then income tax will be due. The amount which has been nominated from income and produced income tax will need to be taken into account and included in the overall calculation of payments on account for the following year.

If an insufficient nomination is made to produce the remittance basis charge of £30,000 (ITA07/s809H(4)) the additional amount treated as nominated will always produce income tax. This will also have a bearing on the payments on account position, even though the additional nominated amount is from an unidentified and unspecified amount of income. The additional amount nominated from income will automatically produce income tax that will become part of the individual's payment on account calculation for the following year.

Effect and treatment of capital gains

Capital gains tax is never included in computing payments on account, so any of the remittance basis charge that is constituted of capital gains tax will not form any part of the following year's payments on account.

Example

Ricardo, a non-domiciled (ND) long-term resident has an income tax liability of £200,000 for tax year 2007-08. Subsequently he makes payments of £100,000 on 31 January 2009 and on 31 July 2009 on account of his liability for 2008-09.

His tax liability for 2008-09 is £250,000, which includes for the first time the £30,000 remittance basis charge. The remaining £220,000 is income tax on UK sources. Ricardo nominated only £21,000 of his foreign income which led to a charge of £8,400 income tax; he also nominated £120,000 foreign chargeable gains which led to a capital gains tax of charge £21,600. Together these constituted his £30,000 remittance basis charge.

Ricardo's payments on account for 2009-10 will be calculated using the £220,000 income tax paid on UK income sources in 2008-09, plus the £8,400 income tax element of the remittance basis charge. This means that he will make payments on account of £114,200 on 31 January 2010 and on 31 July 2010 on account of liability for 2009-10. ...

Payments on account – nominations involving chargeable gains

Capital gains tax is not included in computing payments on account, so any of the remittance basis charge (RBC) that is constituted of capital gains tax will not form any part of the following years payments on account.

There is an additional box on the SA109, if a nomination of capital gains is made in order to pay all or part of the RBC.

This box is called "Adjustments to payments on account" and must be completed if any nomination of capital gains is made. That is because capital gains tax is excluded from the computation of payments on account, and is simply payable as part of the balancing payment on 31 January following the tax year.

This box is not completed if a nomination of income only has been made, as any amount nominated from income will be included in the overall payments on account liability for the following year.

The amount entered in the "Adjustment to payments on account" box on the SA109 is required in order for the payments on account to be calculated correctly for subsequent years:

- where a taxpayer is calculating their liability to tax, the amount for capital gains entered in the box to adjust payments on account, should be excluded in their calculation of payments on account
- if the tax calculation summary page is used the first payment on account for the following year will not include any part of the amount entered for capital gains in the adjustment to payments on account box.

Example involving an amount of capital gains in the "Adjustment to payments on account" box:

Ricardo, who is a higher rate taxpayer decides to nominate both income and capital gains to pay the remittance basis charge.

He nominates as follows:

£21,000 of relevant foreign income	@40%	£8,400
£120,000 of foreign chargeable gains	@18%	£21,600
		£30,000

The amount of £120,000 for capital gains will be entered in the "Adjustment to payments on account" box as this amount will be excluded in calculating payments on account for the following year. Only the £21,000 nominated from income is taken into account when calculating the amount due as payments on account.

If the entire amount nominated to pay the RBC comes from capital gains then it will not be included in the calculation for payments of account. In this case the full amount of nominated gains will be entered in the "Adjustment to payments on account" box.

Payments on account - First-year of paying RBC

The remittance basis charge is only payable from tax years 2008-09 onwards by long-term residents making a claim to use the remittance basis.

For example, if a remittance basis claim is made in 2008-09 and the remittance basis charge is due, then the first year that any payments on account can be considered in relation to the remittance basis charge is 2009-10 unless there is a claim to reduce ...

The fact that their tax liability for 2008-09 will be increased for those paying the remittance basis charge has no effect on the payments on account position for 2008-09 (unless there is a claim to reduce them), but, to the extent that the remittance basis charge is income tax, it will be taken into account when calculating payments on account for 2009-10.

The remittance basis charge for 2008-09 is not due for payment until 31 January 2010 when it can be paid as part of any balancing payment for the year

The same principle applies to the payment on account position in relation to the remittance basis charge for any first year that a claim to the remittance basis is made, and the remittance basis charge is due. Payments on account will not generally be affected until after the first year in which they pay the remittance basis charge (TMA70/s59A(2)).

Payments on account: no remittance basis charge due in following year

When the remittance basis of taxation is **not** claimed in a year following one where the remittance basis has been claimed and the remittance basis charge was paid, the amount of income used to pay part or all of the remittance basis charge may be excluded from the calculations of payment on account.

To allow this to happen, a claim to reduce payments on account may be made on form SA 303. Further information on the rules and the time-limits for making a claim to adjust payments on account can be found in the Self Assessment Manual under SAM1110.

Claim to reduce Payments on Account (PoA)

The payment on account (PoA) position in relation to the remittance basis charge will be affected by any claims to reduce payments on account.

Where the RBC is paid in the previous year on nominated income, the amount feeds through to the individual's payments on account (PoA) for the next year, unless the individual makes a claim to reduce their PoAs on the grounds that their income tax liability for that year will be less than the sum of the two PoAs. For example this could be because they will not claim the remittance basis for the following year. If they subsequently do claim the remittance basis and pay the remittance basis charge in the following year and the income tax due for that year exceeds the sum of the PoAs made we will charge interest on the reduction in the PoA.

This is shown in the example below:

Stage 1

The return shows liability to income tax, which includes the RBC, partly or fully paid in respect of nominated income. The payments on account due on 31 January and 31 July are half of the relevant amount of income tax (TMA70/s59A).

For example, Marie-Clare's 2008-09 income tax liability is £55,000, of which £25,000 related to tax on UK source income, and the remainder is the £30,000 RBC (all in respect of nominated foreign income). Nothing is taxed at source. Her payments on account for 2009-10, payable on 31 January 2010 and 31 July 2010 will each be £27,500.

Stage 2

If the individual does not intend to use the remittance basis for the following year, and so they will not be subject to the remittance basis charge, they can claim to reduce the PoAs.

In the Marie-Clare example, if she does not think she will claim the remittance basis and so will not need to pay the remittance basis charge for 2009-10 she could reduce her payments on account for 2009-10 to £12,500 each, that is 50% of her 2008-09 income tax liability of £25,000 (if the remittance basis charge is excluded). She will of course still have to consider her other income sources and overall expected income tax liability for the year in making this decision.

Stage 3

If the individual subsequently decides to claim the remittance basis and to pay the £30,000 remittance basis charge and a claim to reduce payments on account has been made which resulted in insufficient PoAs being made, then interest will be charged from the due date for the payments on account until a claim to increase payments on account is made or payment is made for the year is paid to stop interest accruing (TMA70/s86).

In the Marie-Clare example, she has claimed to reduce her payments on account to omit the remittance basis charge, so she only makes payments on account of

£25,000 (two lots of £12,500). When she files her 2009-10 self-assessment return her UK income has remained, as expected, at £25,000. However she now decides to claim the remittance basis and so she has to pay the remittance basis charge. As she has erroneously claimed to reduce her payments on account in the year, she will be charged interest on the payments that she should have made, that is, on £15,000 from 31 January 2010 and £15,000 from 31 July 2010 until the date these amounts are paid.

See Self-Assessment Manual – Legal Framework SALF303 for further information on claims to reduce payments on account.

Example 1

- Eva claimed the remittance basis and paid the remittance basis charge in 2008-09, and her income tax liability produces two payments on account for 2009-10 of £120,000 each.
- Eva has decided that she will not be claiming the remittance basis in 2009-10 so will not pay the remittance basis charge. Eva makes a claim to reduce the amount due on account of her tax liability to £200,000 due to a drop in income and because she will not pay the remittance basis charge in 2009-10. When Eva files her 2009-10 return in September 2010 it shows that the tax due on income is £200,000, but these are provisional figures as Eva is awaiting some details from her foreign bankers in relation to some foreign transactions.
- The two £100,000 payments on account appear "correct" at this stage. In November 2010 Eva receives the information from her foreign bankers and decides to amend her return and to claim the remittance basis. She nominates some foreign income and has to pay the remittance basis charge of £30,000, all constituting income tax, bringing her total liability to £230,000.
- Eva will be charged interest on the £30,000 reduction in her payments on account on the grounds that Eva should not have reduced them.

Example 2

- Vali had no foreign income or gains arising in 2008-09, so he did not claim the remittance basis and so he did not need to pay a remittance basis charge in 2008-09.
- Vali's income tax liability for 2008-09 produces two payments on account of £200,000 for 2009-10. No claim is made to reduce the payments on accounts.
- When Vali begins to prepare his 2009-10 return he has a liability of £420,000 income tax on UK sources, so his £400,000 payments on account were correct, based on Vali's previous year's income tax liability.
- Vali has foreign income arising in 2009-10 and he decides to claim the remittance basis in his 2009-10 return. As a long-term but non-domiciled resident Vali has to pay the remittance basis charge of £30,000 bringing his total liability to £450,000. Interest will not be charged on the additional £50,000 tax due, as long as this is paid by the proper due date.[26]

26 See too March 2009 Qs & As Q18.

9.13.7 *Interaction with Gift Aid*

Section 802H(5A) ITA provides:

> The references to income tax in subsection (5) do not include income tax under s.424 (gift aid).

BN55 (22 April 2009) provides:

> 15. The Gift Aid provisions in Chapter 2 of Part 8 of the Income Tax Act 2007 (ITA) allow charities to claim tax relief on any gifts of money from individuals, provided the donor has paid sufficient UK income and capital gains tax in the tax year in which the donation was made. In situations where the donor pays tax on the remittance basis, and is required to pay the £30,000 Remittance Basis Charge under section 809H of ITA, it was always the intention [*sic*] to treat the £30,000 in the same way as other types of income tax or capital gains for the purposes of Gift Aid. Finance Bill 2009 will amend the remittance basis rules to ensure that tax relief under Gift Aid is available in such circumstances.
> 16. This change will have effect from 6 April 2008.

The relief for gift aid (cash gifts to charity) is not extended to qualifying donations relief (gifts of shares and other assets to charity).

9.13.8 *Claim made in error*

Section 809B does not apply unless the individual meets the conditions of s.809B(1)(a) and (b) in the year. So:

(1) A person not sure about his residence may wish to make a claim for the avoidance of doubt and argue the residence position at leisure; if he loses on the residence point the remittance basis claim charge is not due.

(2) A person not sure about his domicile may (if ordinarily UK resident) wish to make a claim and argue the domicile point at leisure; if he loses on domicile the remittance basis claim charge is not due.

On the other hand the claim is effective even if the individual has less than £2k unremitted income and gains, and so would qualify as a sub-£2k remittance basis taxpayer.

9.13.9 *Basic tax planning*

Basic tax planning for spouses will be to arrange that income and gains accrue only to one of them, so that only one has to pay the remittance basis claim charge.

Basic planning for individuals who do not wish to pay the remittance basis claim charge every year is to time disposals and accruals so far as possible that foreign income and gains accrue before the 8th year of residence, and only once every few years subsequently (so a claim is only needed once every few years).

9.13.10 *Remittance basis claim charge: credit against foreign tax*

EN FB 2008 provides:

> 17. As the RBC consists of income tax or CGT paid on the arising basis, ... the tax should be recognised as tax (on income or capital gains, as the case may be) for the purposes of our double taxation agreements.

The proposal in the Draft Clauses published January 2008 was for a simple charge of a fixed amount. This would not have qualified as a credit against foreign tax because it was not a tax on income or gains. HMRC presumably agreed, as the provisions were then recast in order that:

(1) The provisions took the form (as far as possible) of a charge on income or gains but
(2) the provisions had the effect (so far as possible) of a fixed charge.[27]

It will be interesting to see if this sleight of hand satisfies American[28] and other foreign tax authorities. The question is of course one for foreign law, not UK law.

Article 24(1) of the UK/US DTT provides:

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27 See to 9.13.12 (Remittance basis claim charge in years of arrival and departure).

28 For HMRC's opening shot in this debate see BN 107 accessible *www.hmrc.gov.uk/budget2008/bn107.pdf*. It is expected that the United States Treasury and IRS will in due course publish guidance.

> In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income
> (a) the income tax paid or accrued to the United Kingdom by or on behalf of such citizen or resident ...

It is suggested that the *nominated income/gains charge* can in principle be set against foreign tax since it is an income tax or CGT. However the remittance basis *deficit* charge is not a charge on actual income, and cannot be set against foreign tax. HMRC agree. EN Amendments to the Remittance Basis Charge provides:

> 16. The individual claiming the remittance basis might decide to nominate only £50,000 of bank interest under s.[809C(2)] and pay £20,000 of the £30,000 under s.[809H(2)] (assuming higher rate tax is due on all the £50,000). Section [809H(4)] would then apply with the effect that further income of £25,000 is treated as nominated to bring a further £10,000 of income tax into charge. However if the individual intended claiming credit for all or part of the £30,000 under a DTA then DTA relief will only be due on the income or gains actually nominated under s.[809C(2)] – £50,000 of income and £20,000 of income tax in this example. The income tax paid on income treated as nominated under s.[809H(4)] = £25,000 of income and £10,000 of income tax in this example, will not qualify for relief under DTAs as it is not tax on specific nominated income.

It follows that a careful choice of what income or gains to nominate is important, because (if foreign tax allows credit for the £30k UK tax) that can make up to £30k difference to the foreign tax liability.

9.13.11 *DTT relief as defence to the remittance basis claim charge*

FAQ: The £30,000 Charge states:

> **Will the £30,000 charge apply to individuals who are regarded as resident in both the UK and another country with which the UK has a double taxation agreement (DTA)?**
> [1] all years of actual residence in the UK will count towards the seven out of ten test, even if for some or all of those years the taxpayer was

treated as "treaty resident" in another country for the purposes of a DTA tie-breaker.

[2] where a taxpayer is a dual resident (in the UK and another country) and has "treaty residence" in the other jurisdiction, they will need to consider carefully whether a claim for the remittance basis of taxation actually makes financial sense compared to being taxed on the arising basis.

[3] But where a taxpayer has already been UK resident for seven out of the previous nine years and in that year opts to claim the remittance basis, they will be liable to the £30,000 Remittance Basis Minimum Charge, irrespective of "treaty residence", if their unremitted foreign income and gains is £2,000 or more.

Point [1] is clearly right. Point [3] assumes that DTR is not available against the remittance basis claim charge.

It is considered that DTT relief is in principle available against the nominated income/gains charge, but not against the remittance basis deficit charge. The effect of claiming DTT relief against nominated income or gains is to reduce the remittance basis claim charge on the nominated income or gains, but to increase the deficit charge by the same amount.

This certainly defeats the spirit of any DTT. It may also breach the DTT itself. But the intention of Parliament is clear, and the doctrine of parliamentary sovereignty allows Parliament to breach DTTs.[29] How our treaty partners will react to this will be interesting to see.

9.13.12 *Remittance basis claim charge in year of arrival and departure*[30]

The RDR Manual provides:

> Long-term residents who claim the remittance basis under ITA07/s809B are subject to the remittance basis charge of £30,000. This charge is payable in full if the remittance basis is claimed, even in years in which the individual arrives to or departs from the UK part the way through the year, and even if ESC A11 is applied.

In the absence of this guidance one would have expected ESC A11 and D2

29 See *Padmore v IRC (No.2)* [2000] STC (SCD) 356.

30 For the distinct issue of the interaction of the split-year concessions and the definition of "long-term UK resident" see 9.13.1 "Long-term UK resident").

to apply, so that if (for instance) an individual nominated gains accruing after his departure, they would be exempt under ESC D2. It is not constitutionally satisfactory that a relief formally granted by concession should be restricted by informal HMRC guidance: the correct course would have been to revise the text of the concession. But in practice nothing is likely to turn on that.

More fundamentally, what is the reason why the concessions do not apply in this case? If the remittance basis claim charge is a tax on the nominated income or gains, they logically should apply. The reason is that the charge is intended only to take the form of a tax on the nominated income or gains, and it is intended to have the effect of a fixed charge.

9.14 Charge on remitted RFI

Section 809F(1) ITA provides:

> This section applies if s.809B, 809D or 809E applies to an individual for a tax year.

That is, the section applies to remittance basis taxpayers. Section 809F(3) ITA provides:

> The individual's relevant foreign income for that year is charged in accordance with s.832 of ITTOIA 2005.

So we turn to s.832(1) ITTOIA which provides somewhat repetitively:

> This section applies to an individual's relevant foreign income for a tax year ("the relevant foreign income") if s.809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for that year.

We find the rule at last in s.832(2) ITTOIA:

> (2) For any tax year in which—
> (a) the individual is UK resident, and
> (b) any of the relevant foreign income is remitted to the UK,
> income tax is charged on the full amount of the relevant foreign income so remitted in that year.

At first glance it may seem that IT is charged on remitted RFI and not on unremitted RFI. It is not that simple. The scheme of the rewritten legislation is that for every category of income there is:

(1) a charging provision; and
(2) a provision specifying the amount of income on which tax is charged.

For instance, in relation to dividends from non-resident companies, s.402 ITTOIA provides:

> **402 Charge to tax on dividends from non-UK resident companies**
> (1) Income tax is charged on dividends of a non-UK resident company.
> ...
> **403 Income charged**
> (1) Tax is charged under this Chapter on the full amount of the dividends arising in the tax year.
> (2) Subs.(1) is subject to ... Part 8 (foreign income: special rules).

The (subtle) point is that the charge on dividends is under s.402 ITTOIA. Section 403 ITTOIA does not impose a charge. It merely quantifies the amount on which income tax is charged. Likewise s.832(2) ITTOIA does not impose a charge, it merely quantifies the amount on which income tax is charged.[31] The distinction occasionally matters, e.g. references to "income chargeable to income tax" in principle include unremitted income taxable on the remittance basis.[32]

9.15 Charge on remitted gains

Section 809F ITA provides:

> (1) This section applies if s.809B, 809D or 809E applies to an individual for a tax year...
> (4) If the individual is not domiciled in the UK in that year, the individual's foreign chargeable gains for that year are charged in

31 Hence the legislation states that tax is charged "in accordance with" s.832 not *under* s.832. See e.g. ss 13, 14, 16 ITA.

32 The distinction explains why foreign dividend income taxable under remittance basis in 2005/06 and 2006/07 was taxable at the dividend upper rate and not at the higher rate (though this is now of historic interest only); see the 6th edition of this work para 28.4.3.

accordance with s.12 of TCGA 1992.

So we turn to s.12(1) TCGA which provides (somewhat repetitively):

> This section applies to foreign chargeable gains accruing to an individual in a tax year ("the foreign chargeable gains") if—
> (a) s.809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for that year, and
> (b) the individual is not domiciled in the UK in that year.

We find the rule at last in s.12(2)(3) TCGA:

> (2) Chargeable gains are treated as accruing to the individual in any tax year in which any of the foreign chargeable gains are remitted to the UK.
> (3) The amount of chargeable gains treated as accruing is equal to the full amount of the foreign chargeable gains so remitted in that year. ...

While non-ordinary residence is sufficient to qualify for the RFI remittance basis, foreign domicile is needed for CGT.

9.16 Remittance in year after income/gains arise

Suppose:

(1) Income or gains accrue to T (a remittance basis taxpayer) on or after 2008/09 and
(2) The sum is remitted in a subsequent year (in which T is still resident).

The income or gains are taxable in the year of remittance. There is no time limit so income or gains may be taxed many decades after they accrue.

9.16.1 *Transitional rule for pre-2008 income and gains*

Suppose:

(1) RFI accrues to T before 2008/09 and
(2) The RFI is remitted in 2008/09 or later (when T is still resident).

In the absence of a transitional rule, the income would not be taxable under s.832 ITTOIA because the condition in s.832(1) would not be met.

Sections 809B, 809D or 809E did not apply before 2008. Para 83 Sch 7 FA 2008 fills that gap for RFI:

> (1) This paragraph applies to an individual's relevant foreign income for the tax year 2007–08 or any earlier tax year ("the relevant tax year") if—
>
> (a) the individual made a claim under s.831 of ITTOIA 2005 for the relevant tax year, or
>
> (b) s.65(5) of ICTA (or any earlier superseded enactment corresponding to that provision) applied in relation to the individual for the relevant tax year.
>
> (2) Section 832 of ITTOIA 2005 (as amended by this Part of this Schedule) applies in relation to the relevant foreign income as if s.809B of ITA 2007 (claim for remittance basis to apply) applied to the individual for the relevant tax year.

Thus pre-2008 RFI is taxed under s.832(2) if remitted from 2008/09 (as one would expect).

The same applies to gains. In the absence of a transitional rule, pre-2008 gains would not be taxable from 2008/09 because the condition in s.12(1)(a) TCGA would not be met. Para 84 Sch 7 FA 2008 fills that gap:

> (1) This paragraph applies if s.12 of TCGA 1992 (or any corresponding superseded enactment) applied in relation to a gain accruing to an individual in the tax year 2007-08 or any earlier tax year ("the relevant tax year").
>
> (2) Section 12 of TCGA 1992 (as amended by this Part of this Schedule) applies in relation to that gain as if s.809B of ITA 2007 (claim for remittance basis to apply) applied to the individual for the relevant tax year.

9.16.2 *Income arising before 2005/06 remitted before 2007/08: ITTOIA transitional rules*

Para 150 Sch 2 ITTOIA provided:

> A claim may be made under s.831 (claim for relevant foreign income to be charged on the remittance basis) for relevant foreign income to be charged in accordance with s.832 for the tax year 2005–06 or any later tax year, despite that income having arisen in a tax year before the tax year 2005–06; and ss. 832 to 834 apply accordingly.

ITTOIA EN Vol 3 para 347 explains:

> This paragraph ensures that Chapter 2 of Part 8 of this Act is not restricted in its operation to income that arose after the tax year 2004–05 (whenever the earlier income is remitted).

Para 150 was not aptly worded, but what it meant was this: if a s.831 claim is made in 2005/06, 2006/07 or 2007/08, pre-ITTOIA income (which was not taxed on receipt because a claim was made under s.65 ICTA) is taxed under s.832 ITTOIA if remitted in that year.

9.16.3 *Income arising before 2005/06 remitted from 2008/09*

FD Draft Clauses EN 2008 provided:

> 121. Para 47 deletes paras 150 and 151 of Schedule 2 (transitional provisions), which set out transitional arrangements for the application of the remittance basis to certain relevant foreign income arising before the tax year 2005-06. These are now considered obsolete in light of the amendments in this Schedule.[33]

9.17 Remittance after acquisition of UK domicile

Suppose:

(1) RFI/gains accrue to T (a remittance basis taxpayer).
(2) T acquires a UK domicile and for that reason ceases to be a remittance basis taxpayer. T remains UK resident.
(3) T subsequently remits the sum.

This is taxable under the ITA remittance basis.

9.17.1 *Transitional rules for pre-2008 RFI/gains*

The rule for the pre-2008 RFI remittance basis was that there was no IT charge on a remittance after acquisition of a UK domicile. It is considered that the same applied for the pre-2008 CGT remittance basis, though

33 The equivalent passage in EN FB 2008 para 380 is less informative.

HMRC did not accept that.
Suppose:

(1) RFI/gains accrued to T before 2008/09.
(2) T became UK domiciled before 2008/09.
(3) The income/gains are remitted from 2008/09.

T is taxable on the remitted income under s.832(2) ITTOIA. The tax charge is retrospective in that pre-2008 RFI/gains outside the scope of tax has now fallen within the scope of tax.

What is the position if an individual acquires a UK domicile before 6/4/2008 and remitted the income or gains before then? It is suggested that there is no charge because of the cap on the amount remitted; see 10.24.5 (Cap on amount remitted).

9.18 Remittance in year when taxed on arising basis

Suppose:

(1) RFI accrues to T from 2008/09 in a year in which T is a remittance basis taxpayer.
(2) T subsequently remits the income in a year in which he is not a remittance basis taxpayer (because T"s foreign income and gains exceed the £2k limit and T does not claim the remittance basis).

T is taxable on the remitted income under s.832(2) ITA.

9.18.1 *Transitional rules for pre-2008 RFI*

The rule for the pre-2008 RFI remittance basis was that there was no charge on a remittance in a year in which no claim was made for the RFI remittance basis. HMRC accepted that (at least for years when ITTOIA applied). The new rule applies to pre-2008 RFI remitted from 2008/09. The tax charge is retrospective in that pre-2008 RFI/gains outside the scope of tax has now fallen within the scope of tax.

If RFI was remitted before 2008/09, it is considered that there is no charge because of the cap on the amount remitted; see 10.24.5 (Cap on amount remitted).

9.19 Sum arising when resident, remitted when non-resident

Suppose:

(1) Income or gains accrue to T (a remittance basis taxpayer).
(2) T remits the sum to the UK in a year when non-resident.

RFI is not taxable in the year of remittance, because the conditions in s.832(2)(a) ITTOIA are not met. Gains are not taxable in the year of remittance because although the conditions of s.12 TCGA are satisfied (remitted gains are treated as accruing when remitted) the individual (being non-resident) is not subject to tax on chargeable gains.

The temporary non-residence rules need to be considered.

9.20 Remittance after death

Suppose:

(1) RFI or gains accrue to T (a remittance basis taxpayer).
(2) T dies, and the sum is received in the UK after the death.

If the RFI is received in the tax year after death, no tax charge arises because the condition in s.832(2) ITTOIA is not met. If gains are received in the tax year after death, no tax charge arises because (it is considered) s.12(2) TCGA assumes that the individual is alive in the year of remittance. The same applies if there is a remittance in the year of death because the sum cannot be received in the UK by T (who is dead) or by a relevant person (there are no relevant persons in relation to a dead person) so it cannot be remitted (within the definition of that term).

A different rule applies for employment income.

9.21 Remittance after source has ceased

Section 832(3) ITTOIA provides:

> Subs.(2) applies whether or not the source of the income exists when the income is remitted.

9.21.1 *Transitional rules for pre-2008 RFI*

The rule for the pre-2008 RFI remittance basis was that there was no charge on a remittance from a source in a year after the source has ceased. Suppose:

(1) RFI accrued to T before 2008/09.
(2) The source of the RFI ceased before 2008/09.
(3) The RFI is remitted from 2008/09.

Is T taxable on the remitted income under s.832(2) ITTOIA? If so, the tax charge is retrospective in that pre-2008 income outside the scope of tax has now fallen within the scope of tax. It does not matter when the income arose or the source ceased: income arising in the 1950s could now come into charge, though all records relating to it would have been long discarded.

STEP rightly comment:

> It appears that any source ceased funds, whenever the source ceased will be caught by the new rules. The effect of this is to retrospectively change the nature of these funds and this is unfair. If this is to be the case then taxpayers who have used this technique may have placed the funds in capital accounts which will, as a consequence of the changes to the rules, now be classified as mixed accounts. Not only do the mixed account rules fail to take into account the change in nature of these funds which were capital on 5 April 2008 and income on 6 April 2008, but there does not seem to be any clear way to separate out these funds now as the mixed account rules only apply to remittances to the UK. Whilst STEP does not object to the change in these rules for the future, we do feel that it is unfair to impose additional tax and reporting burdens on taxpayers who used a technique in the past which HMRC recognised and accepted when they used it.[34]

What if the source ceased and T remitted the income before 2008/09? Even if the transitional rule does not provide relief, it is considered that there is no charge because of the cap on the amount remitted; see 10.24.5 (Cap on amount remitted).

34 STEP Representations on the FB 2008.

HMRC accept that there is no charge on pre-2008 deemed gains.[35] The same reasoning must apply here so it is considered that pre-2008 source-ceased income remains non-taxable.

9.22 Sum arising when non-resident, remitted when resident

Suppose:

(1) A non-resident individual receives RFI or gains. The income or gains are not of course taxed as they arise.
(2) The individual becomes UK resident, and subsequently remits that sum when taxable under the remittance basis.

RFI remitted is not taxed on remittance as the condition in s.832(1) ITTOIA is not met. Gains remitted are not taxed on remittance because the condition in s.12(1) TCGA is not met.

FAQ Remittances (April 2008) correctly states:

> **Where a non-domiciled individual not resident in the UK, has purchased assets abroad out of income that has not been taxed in the UK, then moves to the UK and becomes resident, will the importation of those assets in the first year be taxed as a remittance?**
> No. As the untaxed income arose while the individual was not UK resident, there is no charge unless the proposed new s.832A ITA 2007 applies (temporary foreign residence).

9.23 RFI from Ireland

In the following discussion:

"Irish income" means RFI arising in Ireland.

"Pre-2008 income" means income arising before 6 April 2008.

The UK/Ireland DTT also needs to be considered but it is not discussed here. Similar points arise in relation to earnings: see 12.16 (Earnings from Ireland).

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35 See 10.25.5 (Transitional rules: gains accruing before 2008/09).

9.23.1 *Income from 2008/09*

The position for income from 2008/09 is straightforward. The ITA remittance basis treats Irish income in the same way as any other foreign income. The FA 2008 repealed the rule of the pre-2008 remittance basis which provided (unlawfully and probably ineffectively) that Irish income was taxed on an arising basis.

9.23.2 *Pre-2008 income remitted from 2008/09*

This change raised the problem of transition. Para 83 Sch 7 FA 2008 provides:

> (1) This paragraph applies to an individual's relevant foreign income for the tax year 2007-08 or any earlier tax year ("the relevant tax year") if—
>
> (a) the individual made a claim under section 831 of ITTOIA 2005 for the relevant tax year, or
>
> (b) section 65(5) of ICTA (or any earlier superseded enactment corresponding to that provision) applied in relation to the individual for the relevant tax year. ...
>
> (3) But nothing in section 832 of ITTOIA 2005 applies in relation to any of the relevant foreign income that arose in the Republic of Ireland.

EN FB 2008 provides:

> 399. Sub-paragraph(3) provides that the new section 832 does not apply to relevant foreign income that arose in the Republic of Ireland. This ensures that no double charge can arise in relation to those tax years during which it was not possible to claim the remittance basis for such income. (This might be relevant for example where income arose in one of those years and was charged on an arising basis but was not remitted to the UK until on or after 6th April 2008.)

Para 83(3) disapplies the remittance basis charge for pre-2008 Irish income. In short, if:

(1) Irish income arose before 2008/09; and
(2) The income is remitted on or after 2008/09

there is no tax charge on remittance.

9.23.3 *Pre-2008 Irish income: tax position before 2008/09 and 2007/08*

As noted above, according to statute, Irish income was taxable on the arising basis: it did not qualify for the remittance basis. The discrimination against Ireland was contrary to EU law.[36] This book advised that those with pre-2008 Irish income should only agree to pay tax on the remittance basis. Where tax has been paid on an arising basis which would not have been paid on a remittance basis, a repayment claim should be made.[37] Under para 83(3) discussed above, pre-2008 Irish income which was not remitted before 2008/09 escapes UK tax altogether, since unremitted Irish income was not lawfully taxable when it arose and it is not (from 2008/09) taxable on remittance.

9.24 Remittance basis for trustees

9.24.1 *Income accruing before 2006/07*

Under the pre-2008 RFI remittance basis, a "person" who satisfies the relevant conditions could claim the remittance basis. The term "person" generally denotes individuals, trustees and companies.[38] The remittance basis therefore applied to trustees as well as to individuals.

Until 2006/07 a trustee qualified for the remittance basis (regardless of the beneficiaries or form of trust) if:

(1) the trustee was an individual domiciled outside the UK; or
(2) the trustee was a company incorporated outside the UK.[39]

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36 The point is more fully discussed in the 6th edition of this work para 9.51.

37 For the limitation period see s.106 FA 2007.

38 Companies were, however, taken out of the remittance basis by s.12 ICTA:

> "... corporation tax shall be assessed and charged for any accounting period of a company on the full amount of the profits arising in the period (whether or not received in or transmitted to the UK) ..."

Companies could formerly qualify for the remittance basis: see 9.4 (History of the remittance basis). This is why some of the old remittance basis cases concern companies.

39 Or (a rare case) if the trustee is resident but not ordinarily resident in the UK.
The domicile of a company is its place of incorporation. Section 12 ICTA does not apply to a company in its capacity as trustee: s.6 ICTA.
The application of the remittance basis to trust income of a UK resident foreign domiciled trustee is recognised in s.720(6)(b) ICTA, *Dawson v IRC* 62 TC 301 at

The TAA provisions may, of course, apply to the trust income if it accrues to foreign domiciled trustees. If one trustee is UK resident and domiciled, and others are UK resident and not domiciled, the trustees as a body did not qualify for the remittance basis; *Dawson v IRC* 62 TC 301.

9.24.2 *Income accruing in 2006/07*

Section 474(1) ITA provides:

> For the purposes of the Income Tax Acts (except where the context otherwise requires), the trustees of a settlement are together treated as if they were a single person (distinct from the persons who are the trustees of the settlement from time to time).

Section 475 ITA goes on to ascribe to trustees a residence but not a domicile.[40] One possible solution is to look to the actual domicile of the trustees in their private capacities. But the trustee is deemed to be "distinct" from the persons who are actually the trustees so it is suggested that this is not the right approach. It is tentatively suggested, by analogy to company domicile, that the domicile should be taken to be the proper law of the trust. Another possibility is to say that trustees are not domiciled anywhere, but then all trustees qualify for the remittance basis, which would be absurd. The usual rule is that everyone has a domicile, and that rule should be applied here.

9.24.3 *Income accruing before 2008/09 remitted after 2008/09*

Since s.832 ITTOIA now only applies to individuals, trustees escape tax on income accruing before 2008/09 which is remitted after 5/4/2007. This is something of a windfall for trustees who qualified for the pre-2008 RFI remittance basis.

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320 and the Trusts Consultative Document (1991) para 10.24.

40 See 4.4 (Trust residence for income tax and CGT). One is looking at the domicile of the *trustees* and not the domicile of the "trust". Thus it does not matter that a trust does not have a domicile in the normal sense. (The Civil Jurisdiction and Judgments Act 1982 attributes a "domicile" to a trust, but the concept of domicile in that Act "has little in common, save in name, with the traditional concept": *Dicey and Morris, Conflict of Laws*, 13th ed., 2000 para 6-002.)

9.25 Forward tax agreements

Details of this arrangement were made public in an article by Malcolm Gunn in *Taxation*, 17 May 2001, under the revealing name "subscription rate method of taxation". The taxpayers involved were very wealthy UK resident non-domiciled individuals.

HMRC required full disclosure of the taxpayer's worldwide assets. The taxpayer then offered to settle the tax liability on foreign sources for a fixed sum. A starting position was that one worked out the taxpayer's UK living expenses; deducted from that the amount of UK income; the balance then represented funds which would be required annually from overseas, on which tax was expected. The forward tax agreement related to foreign income and gains. UK source income remained taxable in the normal way. Malcolm Gunn explained:

> One may be able to negotiate the annual fixed payment downwards on the starting point figure. ... So in the final analysis, it is down to negotiating a deal which both the taxpayer and the Revenue feel they can live happily with.[41]

In the first edition of this book I said:

> It is likely that publication will stop the practice completely. Those who believe that tax should be governed by law will add: Quite right too.

Since then the courts have tried to stop these agreements by holding them to be *ultra vires*.[42] Where such agreements have been made in the past, a taxpayer may have a defence to an assessment if he can show he has suffered prejudice. It is an interesting question how these agreements will deal with the remittance basis claim charge.

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41 Transition from taxation by agreement to taxation by law raises additional problems discussed in Malcolm Gunn's article.

42 *Fayed v Advocate General* 77 TC 273. *Fayed*-style bargaining is however the basis of taxation of wealthy foreigners in many countries, including, I understand, Switzerland, France and Austria. Even in the UK after *Fayed* the temptation is ever present to move from the inconvenience of taxation by law to the convenient (but ultimately corrupt) method of taxation by negotiation.

CHAPTER TEN

THE MEANING OF REMITTANCE

10.1 Meaning of remittance – Introduction

The ITA remittance basis is set out in ss.809K–809Z7 ITA. Section 809K(1) ITA provides:

> Sections 809L to 809Z6 apply for the purposes of—
> (a) this Chapter,
> (b) sections 22 and 26 of ITEPA 2003 (relevant foreign earnings charged on remittance basis),
> (c) section 41A of that Act (specific employment income from securities etc charged on remittance basis),
> (d) section 832 of ITTOIA 2005 (relevant foreign income charged on remittance basis), and
> (e) section 12 of TCGA 1992 (foreign chargeable gains charged on remittance basis).[1]

Thus the ITA remittance basis applies for most (but not quite all) tax purposes. In this chapter I shall not consider the exceptional cases where

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1 Section 809K(2) ITA adds a (somewhat unnecessary) overview in accordance with the principles of Plain English Drafting:
"Those sections—
(a) explain what is meant by income or chargeable gains being 'remitted to the UK' (sections 809L to 809O),
(b) provide for the calculation of the amount remitted (section 809P),
(c) contain rules for attributing transfers from mixed funds to particular kinds of income and capital (sections 809Q to 809S),
(d) contain further provision in relation to certain foreign chargeable gains (section 809T and 809U), and
(e) treat income or chargeable gains as not remitted to the UK in certain cases (see sections 809V to 809Z6)."

the ITA rules do not apply.

10.1.1 *Remittance Conditions A to D*

Section 809L(1) ITA provides:

> An individual's income is, or chargeable gains are, "remitted to the UK" if—
> (a) conditions A and B are met,
> (b) condition C is met, or
> (c) condition D is met.

I refer below to "**remittance conditions A to D**" to avoid confusion with the myriad other conditions in the ITA.

It is considered that s.809L(1) is a comprehensive and not an inclusive definition of remittance, because of the complexity and breadth of the remittance conditions. That is, a sum is remitted if and only if one of these three sets of conditions are satisfied. In practice remittance conditions A and B are the most important.

10.1.2 *Why is the remittance basis difficult?*

The difficulty is inherent in the concept of a remittance basis. Although it is an exaggeration to say that "money has no earmark" it is often very difficult to trace or earmark money.[2] The fungibility between foreign income/gains and other assets makes it hard to determine whether any assets received in the UK should be regarded as the foreign income/gains. But this is what the remittance basis requires to be done.

Before 2008 the matter was largely left to the courts to sort out. It cannot be said that the courts were entirely successful.[3] In 2008 Parliament recast the rules in statutory form. It cannot be said that this is any more successful. The uncertainties are greater than before, complexity and

2 *Lipkin Gorman v Karpnale* [1989] 1 WLR 1340 at 1382 (CA). The law of tracing illustrates this in another context.

3 Thus Viscount Simonds referred to remittances as "this difficult branch of the law": *Thomson v Moyse* 39 TC at p.328. Likewise Finlay J in *Kneen v Martin* 19 TC at p.140: "This subject is always troubling".

record keeping are vastly increased,[4] and no less than before, careful planning is needed to avoid unfairness.

10.2 Relevant person – introduction

Before discussing the remittance conditions, it is necessary to consider the term "relevant person". All four remittance conditions use the term. "Relevant person" is defined in s.809M ITA. Section 809M(1) ITA provides:

> This section applies for the purpose of sections 809L to 809O.

In fact the definition applies throughout the remittance provisions.[5]

A relevant person strictly means the individual to whom income/gains accrue, as well as certain persons connected to him. But in the discussion below I generally refer to the individual himself as "the individual" and use the term "relevant person" to mean the others within the statutory definition.

Strictly one should not use the term "relevant person" in the abstract. A relevant person can exist only *in relation to an individual*. But where the context is clear it is permissible simply to refer to a relevant person.

Section 809M ITA sets out eight categories of relevant person. These can be split into three groups: close family, family companies and family trusts.

10.3 Relevant person – close family

The first four categories of relevant person are close family. Section 809M(2) ITA provides:

> A "relevant person" is—
> (a) the individual,
> (b) the individual's husband or wife,
> (c) the individual's civil partner,

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4 The topic which took up 78 pages in the 2007/08 edition of this work is covered by more than 200 pages in the 2009/10 edition.

5 The term "relevant person" is also used in s.809Z2 where the drafter has to say expressly that the s.809M definition applies, and in transitional provisions.

(d) a child or grandchild of a person falling within any of paras (a) to (c), if the child or grandchild has not reached the age of 18.

10.3.1 *Persons living together*

Section 809M(3) ITA provides:

> For that purpose—
> (a) a man and woman living together as husband and wife are treated as if they were husband and wife;
> (b) two people of the same sex living together as if they were civil partners of each other are treated as if they were civil partners of each other.

This provision treats cohabitees as married persons and so relevant persons. This is a new development in tax, though it will probably become standard in future anti-avoidance provisions.

The ACG–WFTC/DPTC Applicant Compliance Guide has some guidance:

> **9010. Definition of LTHAW [Living Together as Husband and Wife]** [January 2008]
> Since the inception of the Welfare State in 1945 the question of whether a man and woman live together as husband and wife has proven to be a difficult and sensitive subject. Since 1977 the DSS have had a common approach to this situation regardless of the type of benefit being claimed. The Inland Revenue (HMRC from April 2005) has adopted that same approach for WFTC.
> The principal (*sic*) behind this is that an unmarried couple should not be treated any more or less favourably than a married couple.
> The law says there are certain consequences for entitlement to tax credits where an applicant is part of an "unmarried couple". "Unmarried couple" is defined as "a man and a woman who are not married to each other but are living together as husband and wife…" ...
> Living together as husband and wife has its normal meaning in everyday language but the courts and administrative practice have developed a number of criteria to help apply that meaning to situations that may occur. When all of these criteria have been examined, the question as a whole still needs to be answered; do this man and woman live together as husband and wife.
> These criteria are:–
> - Live in the same household.
> - Stability of relationship
> - Financial support

- Sexual relationship
- Dependent children
- Public acknowledgement.

In both post and pre-award cases no single point can decide the question of living together as husband and wife. It is essential to have as much information as possible on all of the points to consider them as a whole. ...

9011. Live in the Same Household [January 2008]

(This text has been withheld because of exemptions in the Freedom of Information Act 2000) ...

9012. Stability of Relationship [January 2008]

(This text has been withheld because of exemptions in the Freedom of Information Act 2000) ...

9013. Financial Support [January 2008]

(This text has been withheld because of exemptions in the Freedom of Information Act 2000) ...

9014. Sexual Relationship [July 2004]

This is obviously the most difficult area of LTAHAW to deal with. Whilst the question of whether or not a sexual relationship exists is important when attempting to establish the nature of a couple's relationship as a whole it should not be considered in isolation.

The Benefits Agency experience shows that it is quite common for people to claim a lack of a sexual relationship to prove they are not LTAHAW. It is however impossible to prove the sexual nature of a relationship.

The italicised passage was in the Manual in January 2008. Now the published version (somewhat implausibly) claims exemption under the FOIA 2000. I think it is a safe bet that the same words survive in the unpublished guidance. It may be deleted because of embarrassment rather than any ground in the FOIA. For although the censored passage states that a sexual relationship is important, in the following sections officials are instructed never to ask questions about it.

9016. Public Acknowledgement [January 2008]

(This text has been withheld because of exemptions in the Freedom of Information Act 2000)

4017 Sensitivities [January 2002]

The question of whether or not a couple is LTAHAW is very difficult to establish and enquiries into this aspect of an application should be handled with care. Asking the applicant questions about the nature of their relationship with another person may often provoke a defensive or aggressive response particularly when the applicant realises that their entitlement to WFTC may be affected.

Important points to remember are:–

- Ensure your personal safety at all times
- Record fully all questions asked and the responses given

- Remain neutral, polite and courteous
- Give the person time to answer questions
- Be firm if necessary to obtain answers
- Never ask questions about the sexual nature of a relationship
- Avoid using the term partner when questioning applicant.
- Ensure applicant's right to confidentiality
- Do not undertake surveillance, except as permitted by memo SCS33/2001 see ACG03009

9020. Investigation Approach [January 2008]
(This text has been withheld because of exemptions in the Freedom of Information Act 2000)
9021. Information to ask for [January 2008]
(This text has been withheld because of exemptions in the Freedom of Information Act 2000)
9022. Explanations Offered by Applicants [January 2002]
There are a number of explanations which may be offered by the applicant for not declaring the presence of a partner, e.g..

- He/she is not here all the time (works away)
- Thought he/she could stay 3 nights a week without it affecting entitlement
- He/she lives at another address
- He/she gives me no money
- He/she is not the father/mother of my children
- He/she is a lodger/just a friend
- We do not have sex

You should consider these explanations in relation to the 6 criteria, at 9010 and the facts should be pursued.

- If suspected partner lives at another address is this address real or a postal address. Perhaps a friend has provided a convenient address. If the suspected partner does have a genuine address it is impossible to prove living together. Check the address against the voters list, in the TPI Data Mart, the Departmental Central Index and the SA record.
- The "3 night rule" does not exist and the other criteria need to be considered in order to establish the true picture.
- Whilst the suspected partner may not contribute to the household finances this point in isolation is irrelevant.
- The parentage of the children is not relevant and the other criteria should be examined
- If it is claimed that the suspected partner is a lodger then they should pay rent. Establish the details of the amount of rent paid, the frequency and any documentary evidence.
- The sexual relationship (or lack of sexual relationship) of a couple does not, on its own, establish whether or not the couple are LTAHAW.

The Independent Taxation Manual provides:

605. Living together as husband and wife

There is a similar rule for various Social Security benefits. Court decisions in these cases show that no one fact necessarily decides whether a man and a woman live together as husband and wife. But the Social Security rule is used for some benefits where no children are involved. This is important because in Additional Personal allowances cases there will be children. In such cases Social Security precedents show that a couple almost certainly live together as husband and wife if they are both the parents of children who reside with them.

Where only one partner is the parent of the children the couple live together as husband and wife if they and the children generally behave like a family.

Sometimes you need to take other factors into account. Further guidance is set out below.

606. Membership of same household

A couple are unlikely to live together as husband and wife unless they live in the same household. But absences caused by work, visits to relatives and the like do not mean they are not living together as husband and wife.

607–609.

610. Stability of relationship

A couple are not living together as husband and wife if they have a very brief or occasional relationship.

When a couple first live together it may be clear at the start that they are living as husband and wife. For example, when the woman takes the man's name and bears his child. But in other cases it may take more time before such a close relationship develops.

611. Life time bond is not essential

We are looking for the same kind of stable relationship as is normally found in a marriage. One of the main features of a marriage is that the couple bind themselves to each other for life. An unmarried couple may not make such a formal commitment, but they can still live together as husband and wife. They do not have to intend to stay together permanently. It is enough if they intend to stay together for the foreseeable future.

612. Start of relationship

It can be hard to decide when a couple begin to live together as husband and wife. The Additional Personal allowance rule applies if the couple live together for part of a year – even one day – as long as they do so as husband and wife. But do not spend time on marginal cases. Normally you accept what the couple tell you.

613. End of relationship

It can also be difficult to decide when a relationship ends and you should generally accept what the couple tell you. But if the couple have lived together as husband and wife in the past it is usually easier to show that the relationship continues. Woolf J said this in a 1982 decision

> "Once one has established the relationship to exist then it is much easier to show that it continues, and it may well be that although many of the features of living together between husband and wife have ceased, perhaps because of advancing years or other reasons, the paragraph will still continue to apply. This would be the position even though a court would have come to

> a different conclusion as to whether the paragraph applied, if at the outset all that existed was that state of affairs."
>
> (*Crake v Supplementary Benefits Commission* [1982] 1 All ER p. 502h)
>
> **614. Financial support**
>
> In a marriage we normally find that one partner supports the other, or there is a sharing of household expenses. Where an unmarried couple also do this they are more likely to be living together as husband and wife.
>
> But the absence of these features does not prove the couple are not living together as husband and wife. After all, a married couple can keep their financial affairs quite separate.
>
> **615. Sexual relationship**
>
> The couple's sexual relationship is of little help in deciding whether they live together as husband and wife. There are two reasons for this.
>
> First, there may be no sexual relations in a marriage; for example, where elderly persons marry for mutual comfort and support. Second, sexual relations occur outside marriage and outside any intention to live together as husband and wife. So their presence or absence proves little.
>
> Do not ask any questions about the sexual relationship of a couple or about the sleeping arrangements in the household.
>
> Take note of any information the taxpayer volunteers but bear in mind that it is unlikely to be conclusive for the reasons given above.
>
> **616. How other people see relationship**
>
> A couple can live together as husband and wife even if they keep their own surnames. But it is a strong pointer to a husband and wife relationship if they call themselves "Mr and Mrs X".

The RDR Manual makes a self-evident point:

> There is a no minimum period for cohabitation; it is a question of fact as to whether two individuals are living together as spouses or civil partners.

10.4 Relevant persons – UK resident family companies

Under s.809M(2) ITA the next category of relevant person is:

> (e) [i] a close[6] company in which a person falling within any other paragraph of this subsection is a participator, or

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6 Section 809M(3)(c) ITA provides the standard definition:

> "'close company' has the same meaning as in the Corporation Tax Acts (see sections 414 and 415 of ICTA)."

[ii] a company which is a 51% subsidiary[7] of such a close company.[8]

This is intended to catch family companies but it is widely drawn. Companies may also be caught as bodies connected to trusts.[9]

10.4.1 *"Participator" from 22 April 2009*

The key term here is "participator". In the following discussion:

The "**standard definition**" of participator is that in s.417(1) ICTA.

The "**wider than standard definition**" of participator is that in s.417(1) as extended by s.419(7) ICTA. (This definition applies for the purposes of s.419 ICTA.)

From 22 April 2009 s.809M(3)(ca) ITA provides the wider than standard definition:

> "participator", in relation to a close company, means a person who is a participator in relation to the company for the purposes of section 419of ICTA (see sections 417(1) and 419(7) of that Act).[10]

10.4.2 *"Participator" before 22 April 2009*

In the original 2008 legislation "participator" was (somewhat negligently) left undefined. What was the position between 6 April 2008 and 22 April 2009? Section 809M(3)(c) ITA provided that close company had the meaning given by ss.414 and 415 ICTA 1988. As s.417(1) ICTA defines "participator" for the purpose of sections 414 and 415, it is considered that the standard definition should be taken to apply for the purposes of s.809M.

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7 Section 809M(3)(cb) ITA provides:

> "'51% subsidiary' has the same meaning as in the Corporation Tax Acts (see section 838 of ICTA)."

8 Para [ii] added from 22 April 2009. If the Budget had been sooner, they would have taken effect from the beginning of the tax year, which would have been easier, but there it is.

9 See 10.7 (Body connected to trust).

10 For this definition see 63.14 (Definition of participator).

10.4.3 *Subsidiary of close company*

Section 809(2)(e)[ii] ITA was added by the FA 2009 with effect from 22 April 2009. In the absence of this provision, whether a person is a participator in a 51% subsidiary depends on his holding in the parent company.[11]

10.5 Relevant persons – non-resident family companies

Under s.809M(2) ITA the next category of relevant person is:

> (f) a company in which a person falling within any other paragraph of this subsection is a participator, and which would be a close company if it were resident in the UK,

There is no definition of "participator" here[12] but if the view taken above is correct, the standard (s.417(1) ICTA) definition applies.

The term "relevant person" is not extended to include subsidiaries of non-resident close companies. It is difficult to see any reason for distinguishing between UK resident close companies and non-resident close companies, and the explanation is presumably that the 2009 correction to the misdrafted 2008 legislation is itself misdrafted.

10.6 Relevant persons – trusts

Under s.809M(2) ITA the next category of relevant person is:

> (g) the trustees of a settlement of which a person falling within any other paragraph of this subsection is a beneficiary.

This is intended to catch family trusts but it is so widely drawn it covers many if not most trusts in existence.[13]

I refer to a trust within s.809M(2)(g) as an "**RP trust**".

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11 See 63.14.2 (Chain of partly owned companies).

12 The definition in s.809M(3)(ca) applies only to a *close* company.

13 EN Clause 23 Schedule 7 Remittance Basis Amendments 482 to 493 states:

> "A trustee of a settlement will only be treated as a "relevant person" if the individual or immediate family members can benefit from the settlement."

This is wrong because of the rules relating to close companies.

Section 809M(3)(d) ITA provides:

> "settlement" and "settlor" have the same meaning as in Chapter 2 of Part 9.

This brings in the standard IT/CGT definition of "settlement" and "settlor". At first glance the definition of "settlement" is otiose since the definition in Chapter 2, Part 9, ITA applies except so far as the contrary intention otherwise requires; but it does no harm.

The definition of "settlor" is otiose as the word is not used in the definition of "relevant person".

Section 809M(3)(e) ITA defines "beneficiary":

> "beneficiary", in relation to a settlement, means any person who receives, or may receive, any benefit under or by virtue of the settlement;

Thus every trust with an unrestricted power to add beneficiaries (which is a standard form) is an RP trust. But if the power to add is only exercisable with the consent of an individual the position is different.

If T is excluded but lends interest-free to the trust, the trust becomes an RP trust in relation to T.

It is considered that a trust is not an RP trust in relation to T if its terms provide that children or grandchildren of T can benefit, but only after they have reached the age of 18.

10.7 Body connected with trust

Under s.809M(2)(h) ITA the last category of relevant person is:

> (h) a body connected with such a settlement.

"Connected with" is very widely defined. Section 809M(3)(g) ITA provides:

> a body is "connected with" a settlement if the body falls within section 993(3)(c), (d), (e) or (f) as regards the settlement.

In order to follow this one needs to set out the relevant parts of s.993(3)

ITA:

> (c) any close company whose participators include the trustees of the settlement,
> (d) any non-UK resident company which, if it were UK resident, would be a close company whose participators include the trustees of the settlement,
> (e) any body corporate controlled (within the meaning of section 995) by a company within para (c) or (d),

Paras (c) and (d) are otiose, because any company within (c) or (d) would fall within s.809M(2)(e)(f).[14] An individual would not usually know whether or not a company is a relevant person in relation to him because he cannot tell whether or not there might be a participator who is a trustee of a settlement with power to add beneficiaries.

Section 993(3) ITA continues:

> (f) if the settlement is the principal settlement in relation to one or more sub-fund settlements, a person in the capacity as trustee of such a sub-fund settlement.

I cannot make sense of the reference in s.809M(3)(g) to s.993(3)(f). I expect the drafter only intended to refer to s.993(3)(c), (d), (e) and the reference to (f) slipped in by mistake. But since sub-fund settlements are dead-letter tax law (never found in practice) the point does not matter.

Lastly, s.809M(3)(f) ITA provides:

> "trustee" has the same meaning as in section 993 (see, in particular, section 994(3)).

So we need to turn to s.994(3) ITA:

> For the purposes of section 993 "trustee", in the case of a settlement in relation to which there would be no trustees apart from this subsection, means any person—
> (a) in whom the property comprised in the settlement is for the time being vested, or
> (b) in whom the management of that property is for the time being

14 Because the trustees are participators.

vested.

Section 466(4) does not apply for the purposes of this subsection.

Section 809M(3)(f) (incorporating s.994(3)) is misconceived. Section 994(3) makes sense in the context of s.993 ITA where settlement means settlement-arrangement (which need not have trustees.) It does not make sense in the context of s.809M ITA where settlement means classic settlement, which must have trustees. But no significant harm arises from this mistake.

10.8 Relevant and other persons – duties and compliance

Suppose:

(1) an individual gives income or gains to a relevant person ("R"); and
(2) R remits sums to the UK.

The individual in principle becomes liable to a tax charge. The residence of R does not matter.

However, R is under no duty to inform the individual that he has remitted sums to the UK. R is under no duty to inform HMRC, as any tax liability on the remittance is that of the individual, not of R. But the rules in theory require R to keep records for the lifetime of the individual.
Similar issues arise in relation to remittance condition C. Suppose:

(1) an individual gives income or gains to a non-relevant person ("G", a gift recipient); and
(2) qualifying property is enjoyed by a relevant person (or used in respect of a relevant debt).

The individual in principle becomes liable to a tax charge. The residence of G does not matter. G is under no duty to inform the individual or HMRC. But the rules in theory require G to keep records for the lifetime of the individual.

Similar issues arise in relation to remittance condition D, where any property of any third person ("P") is enjoyed by a relevant person (or used in respect of a relevant debt) and there is a connected operation (as defined.) The individual in principle becomes liable to a tax charge. The residence of P does not matter. P is under no duty to inform the individual that he has remitted sums to the UK or to inform HMRC. But the rules in theory require P to keep records for the lifetime of the individual.

Of course in practice these rules will not (and indeed could not) be observed except in straightforward cases.

The individual has no indemnity against the relevant person, gift recipient or third party.

Under the pre-2008 remittance basis, if A (a remittance basis taxpayer) transferred his foreign income to any other person ("B") and B receives that income abroad, there was in general no remittance of that income if B subsequently remits the income to the UK. In the 6th edition of this book I said:

> The law could hardly be otherwise, for A will not usually know what B does with his money after it has been transferred to B.

I was wrong about that! My comment assumed that workability was a necessary requirement of UK anti-avoidance provisions. Now it is sufficient if the law is workable in simple cases. Now if T gives income to a relevant person, who remits, T is taxable.

A relevant person who bears a grudge against an individual (e.g. a separated spouse) may be able to trigger a significant tax charge out of spite, by deliberately remitting income or gains he has received from the individual. He may alternatively blackmail the individual by threatening to remit unless paid not to do so.

What about a gift recipient (such as an estranged adult child)? There is no charge if they remit income or gains they have received from the individual. What if they apply property they have been given for the benefit of a relevant person, eg a minor child or grandchild of the individual? This arguably does not constitute a taxable remittance under condition B, because the sums are not derived property, but it is caught by remittance condition C.

Also see 10.15 (Proceeds of divorce settlement).

The RDR Manual provides:

> Where an individual gives untaxed foreign income or gains to another person then they should ensure the donee is aware that they must tell the donor if the property or anything subsequently derived from it is bought to the UK in circumstances such that there would be a remittance under ITA07/s809L.

There is no statutory obligation to do this but failure will make compliance difficult.

HMRC say in March 2009 Qs & As Q9:

> If
> [1] the record keeping requirements are felt to be too onerous and
> [2] the probability of remittance to the UK is high
> the donor may wish to consider making a gift of taxed income or gains.

This will not satisfy readers. If "the probability of remittance to the UK is high" then the donor may indeed prefer a gift of taxed income or gains,[15] quite regardless of the record keeping requirements. Conversely, what advice would HMRC give if the record keeping was felt to be onerous but the probability of remittance was low? Or if the donee had insufficient taxed income or gains to make the gift?

10.9 Relevant person transitional rule for pre-2008/09 income and gains

Para 86(4) Sch 7 FA 2008 provides:

> Subject to sub-paras (2) and (3), in relation to an individual's income and chargeable gains for the tax year 2007-08 or any earlier tax year, section 809L has effect as if the references to a relevant person were to the individual.

This rule restricts the scope of remittance conditions A and B. However in important respects the same rule increases the scope of remittance conditions C and D.[16]

The December 2008 Qs & As provide:

> **Q1** If income has been gifted by father to an adult son before 6 April 2008 does it matter how long ago it happened?
> **A** If income was gifted by a parent to an adult child before 6 April 2008 than para 86 of Schedule 7 Finance Act 2008 applies. The child may remit the gift to the UK after 5 April 2008 without triggering a charge to tax on the father provided that the father does not benefit from the

15 Or other tax-free capital.

16 See 9.17.6 (Transitional rules: pre-2008 income/gains) and 9.19.4 (Transitional rules: pre-2008 income/gains).

> remittance, or anything derived from it.

Ths is correct but misleading because the same applies to a gift *after* 6 April 2008, all that matters is that the income/gains arose before then. HMRC agree. The December 2008 Qs & As provide:

> **Q2** Are my assumptions correct in the following scenarios?
> Non-UK domiciled, UK resident individual (X). Relevant Foreign Income (RFI) arisen in tax year 2007-08.
> 1. X gifts RFI to relevant person (RP) in 2008-09. RP remits RFI to UK (not for X's benefit). Under para 86(4) Sch 7 FA 2008 no taxable remittance.
> X uses RFI to purchase asset in 2008-09. X gifts asset to RP who remits to UK (not for X's benefit). Under para 86(4) Sch 7 FA 2008 no taxable remittance.
> 2. Para 82(2) to (4) only seems to be relevant to the "individual" not other "relevant persons" eg gift of asset (purchased out of RFI) at any time pre 6 April 2008 by X to RP followed by remittance to UK in 2008-09 not taxable as protected by para (5).
> **A.** Para 86(4) of Schedule 7 to FA 2008 means that remittances of income and gains arising before 6 April 2008 that have been genuinely alienated are not taxable upon the donor. The assumptions at (1) and (2) are correct.
> The provisions of 86(2) and (4) apply only to RFI and protect remittances from being chargeable to tax where the RFI or other property deriving from the RFI was brought to the UK before 6 April 2008 or where property deriving from RFI was acquired before 12 March 2008 and is subsequently brought to the UK.

Question 3 of the December 2008 Qs & As is apparently inconsistent with this view, but if that is intended it is clearly wrong.

10.10 Relevant persons: commentary

If an individual remits his own income to the UK, he is able to spend it here and there is some sense in taxing him. The same might be said for an individual's spouse and minor children. A case could be made to extend the class to other close family.

Para (d) – applying to minor grandchildren (though not to adults) – is a novel development in tax. The policy is inconsistent with other anti-avoidance provisions, and leads to some strange anomalies and nonsense.[17] The intention is perhaps to catch grandparents paying the school fees of their UK resident grandchildren – at least if the school is in the UK. But that is only a surmise, as the Government never published any explanation of the anomaly.

When a family trust or a family company remits its income to the UK, the individual (as beneficiary or shareholder) is not in any way advantaged unless and until the trustees decide to transfer the income to him or to a close family member. The main effect of the present rules is to impose a prohibitive tax charge on investment in the UK by the foreign domiciliary or relevant persons. In order to impose this comprehensively, the definition of relevant person is made extravagantly wide. What on earth is the thought process that has led to this outlandish situation? Needless to say, there was no discussion of these policy issues when the rules were announced (I infer that it is based on a doctrinaire conception that the remittance basis requires funds to be taxed if and when *the funds* come to the UK. The policy ought surely to be to charge tax when funds are available *for personal spending* in the UK, not simply because they are invested here.

For these reasons the definition of relevant person ought to be restricted to the individual, his spouse and minor children (and if necessary, though I would have thought not, his cohabitee.)

10.11 Remittance condition A

Remittance conditions A and B go together: condition A requires a UK connection, and condition B requires a link to the foreign income or gains. Both conditions need to be satisfied to have a remittance under s.809L(1)(a).

Section 809L(2) ITA provides:

> Condition A is that—
>
> (a) money or other property is brought to, or received or used in, the UK by or for the benefit of a relevant person, or
>
> (b) a service is provided in the UK to or for the benefit of a relevant person.

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17 See 10.27 (School fees).

There are eight ways to satisfy remittance condition A:

(1) Property is:
  (a) brought to the UK by a relevant person
  (b) brought to the UK for the benefit of a relevant person
  (c) received in the UK by a relevant person
  (d) received in the UK for the benefit of a relevant person
  (e) used in the UK by a relevant person
  (f) used in the UK for the benefit of a relevant person
(2) A service is:
  (a) provided in the UK to a relevant person
  (b) provided in the UK for the benefit of a relevant person

I refer to property within (1) as "**UK property**" and a service within (2) as a "**UK service**".

10.11.1 *Enactment history*

At first glance the wording of remittance condition A is loosely derived from the pre-2008 ss.33(2) ITEPA and 12(2) TCGA, but the connection is tenuous. Section 33(2) ITEPA provided:

> *If general earnings are—*
> *(a) paid, used, or enjoyed in the UK, or*
> *(b) transmitted or brought to the UK in any manner or form,*
> *they are to be treated as remitted to the UK at the time when they are so paid, used or enjoyed or dealt with as mentioned in para (b).*[18]

In the current provision, the terminology brought/received/used has replaced paid/used/enjoyed/transmitted/brought, but that is just a simplification without change of meaning.

The former words "in any manner or form" have been omitted, but they

18 The wording was perhaps intended to extend the concept of "remittance" beyond that which applied for the pre-2008 RFI remittance basis. Though it is just as likely that the drafter only had in mind a plain English paraphrase of the antique language of the former s.65 ICTA 1988. There is no authority discussing these words. (The question was raised but left open in *Harmel v Wright* 49 TC 149.) The question will not now be decided.

are unnecessary as the concept of "derived property" in remittance condition B does the same work.

The words "for the benefit of" are new. The reference to a relevant person is new.

The wording is so different that pre-2008 authorities on the remittance basis need careful review to see if they are still applicable under the ITA remittance basis, though some are still useful.

10.11.2 *Property*

Sections 809L to 809V refer on some occasions to "money or other property" and on other occasions simply to "property." It is clear that the word "property" alone includes money, that is, it is equivalent to "money or other property". I follow this usage here.[19]

10.11.3 *Property brought to or received in the UK*

The first two ways to satisfy remittance condition A are:

(a) Property is brought to the UK by a relevant person
(b) Property is brought to the UK for the benefit of a relevant person

Para (b) might apply if N holds property as nominee for T, and N brings the property to the UK.

The next two ways to satisfy remittance condition A are:

(c) Property is received in the UK by a relevant person
(d) Property is received in the UK for the benefit of a relevant person

Para (d) might apply if N holds property as nominee for T, and N receives the property in the UK.

19 Confusingly the word "property" is used in a different sense in s.809X to s.809Z5 ITA. See 10.44.1 ("Property").

Why do we need "brought" as well as "received"? What does it add? T can receive an asset in the UK without bringing it here (e.g. on the purchase of a UK situate asset). Can T "bring" an asset to the UK without receiving it in the UK? Perhaps if T packs an item in her hand luggage, T "brings" it here but does not "receive" it here as there is no identifiable movement of "receipt". So both words are needed.

10.11.4 *Banking machinery and property in transit*

What if the transfer to a foreign bank account involves credits in UK accounting records of the foreign bank (this is understood to be the position for Channel Island and IOM banks)? No difficulty arises. The RDR Manual provides:

> *Banking Transactions*
> Transfers between foreign centres often pass through the UK banking system, for example when a sterling payment is made abroad and the payment is cleared through London in the normal banking process.
> In such circumstances HMRC do not regard the passage of funds through the UK as being a taxable remittance.
> The machinery employed is irrelevant provided that, without express provision, the individual has:
> - no right to payment at any intermediate point; and
> - no control over the funds transferred by their foreign bank to secure payment at the agreed point.

This approach is extended in March 2009 Qs & As Q17:

> **Q17:** Will HMRC apply the same principle, expressed in relation to mechanistic banking transfers which pass through the UK in the banking system, in a case where a courier passes through the UK in transit carrying property not covered by the temporary importation exemption?
> **A:** Yes. In principle, where the "passing through" is a mechanistic part of the courier service provision and, no relevant persons have any rights to use or access the property at any intermediate point; and no control over how property is transported to and from the agreed points. In such circumstances the passage of property which merely "touches" the UK would not be regarded as a sum remitted to the UK

10.11.5 *Gift or transfer to non-relevant person*

In *Timpson's Executors v Yerbury*[20] cheques representing foreign income of Mrs Timpson ("T") were given to T's children, cashed by them and credited to their bank accounts in the UK. Thus, the foreign income was received in the UK, but it was not received by T. This was nevertheless held to be a taxable remittance by T. Romer LJ and (I think) Greene LJ decided *Timpson's Executors* on the basis that there is a remittance if:

(1) money is received in the UK by a third party at T's direction, and
(2) immediately before receipt, the money (or funds representing it) belonged to T.[21]

This is no longer the law under the ITA remittance basis. Remittance condition A requires that property is brought/received/used in the UK by

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20 20 TC 155 followed at first instance in *Walsh v Randall* 23 TC 55.

21 "The Rule does not require that the sum should have been received by the person entitled to the income. In computing the tax, therefore, sums paid to third parties [in the UK] for the benefit or at the request of the party so entitled have to be taken into account..." (Romer LJ at p.181); "provided the income in respect of which the assessment is made is income to which the person assessed is entitled, it is, in my judgment, immaterial whether the sum 'received in the UK' is received by him or by some third party upon his instructions." (Greene LJ at p.186).
Lord Denning adopted this reasoning in an obiter comment in *Thomson v Moyse*:

> "But [the taxpayer] need not receive [the foreign income] himself. It is sufficient if the sums are received *in England* by some third person *by his authority*. Thus, if Mr Moyse, instead of receiving the money himself, tells his New York banker to send a remittance to his butcher or baker or candlestick-maker in England, he is chargeable with tax on it for the simple reason that he was "entitled" to the income which has been used to pay the debt; and he must pay tax on it *when it is received in England*, no matter by whom it is received, so long as it is received *by his authority* ..."

Lord Wright MR decided *Timpson's Executors* the case on a different basis, that: "if the sums in question were received in the UK as the income of Mrs. Timpson she was chargeable to tax as being the person entitled to it when it came into the UK, though in fact she never received it herself.... if it comes here as her income, ... the fact that on arrival it is applied, in accordance with her directions, in payment to others does not affect its chargeability to her;" 20 TC at p.180. Clearly T did not receive the income, but Lord Wright said that she was entitled to it on arrival, when it came to the UK. This, with respect, is not tenable for reasons given in the 6th edition of this book; but the point does not now matter.

a relevant person. So if a foreign domiciliary writes a cheque on a foreign bank account, gives it to a donee (not a relevant person) who cashes the cheque in the UK, there is no remittance of the foreign income. The money is brought to the UK by the donee (not by a relevant person).

Suppose T transfers income from an offshore account direct to the UK account of a donee (not a relevant person) by electronic transfer (not by cheque). It is arguable that there is no taxable remittance. It would be strange if there were a difference between sending a cheque and a direct electronic transfer. But in this case it might be said that T "brought" the money into the UK (even though he did not receive or use it in the UK).

The practice before 2008/09 was to make the gift or transfer abroad (by payment into a foreign bank account of the transferee) and this practice will no doubt continue even though it is not on this analysis strictly necessary.

10.11.6 *Property used in the UK*

The next way to satisfy remittance condition A is:

> *(e) Property is used in the UK by a relevant person*

This requires one to ask whether property is used, where property is used, who is the user, and what exactly is the property which is used.

It is suggested that "used" means enjoyed in specie, and property is used where it is situate. E.g. a picture or other chattel is used where it is situate. So if a sum is applied in the purchase of chattels which are brought to the UK and used by the individual, or any relevant person, remittance condition A is satisfied.

Suppose:

(1) T gave pre-2008 RFI to his spouse and the spouse uses the money to buy a house jointly with T; or
(2) T gives RFI to his brother (not a relevant person) and the brother uses the money to buy a property jointly with T.

Suppose the co-owners occupy the property jointly. It is considered T does not "use" the co-owner's half share, so there is no remittance of the RFI.

Suppose T gives RFI to his adult son S, and S uses the money to purchase a UK residence which is occupied by S, not by T. Condition A is not satisfied. S uses property in the UK but S is not a relevant person. Suppose S has a minor child, GS, who also lives in the property. It is suggested that the property is not "used" by GS, who is merely a licensee of S. Any "use" by GS is incidental to the primary use by S, and should be ignored. It is different if S leaves the property and GS becomes the occupier (but since GS is by then likely to be 18, he ceases to be a relevant person).

If money is spent, it is "used" in the normal sense of the word. However it is not clear where spent money is used, so it is not clear how one decides whether it is used in the UK. It is suggested that the spending of money is within the receipt/debt categories, and so (say) paying a debt may be a remittance under the debt remittance rules but it does not satisfy condition A: the money is not used in the UK.

10.11.7 *UK asset not used in specie*

What is the position if T uses a sum (outside the UK) to pay the purchase price of UK situate property which is not enjoyed *in specie*? For example, if it used to purchase UK situate shares or land let as an investment?

Assume that the sum itself is not received in the UK (because payment for the asset is made to the vendor outside the UK).

At first sight, remittance condition A is satisfied on the grounds that

(1) income is "brought to" the UK or
(2) property (the shares or land) is "received in" the UK

It is arguable that condition A is only satisfied if the relevant individual actually uses the assets, and merely acquiring UK situate assets is not enough.[22] The EI Manual suggests that HMRC adopted this view for the pre-2008 employment income remittance basis,[23] and the language has not materially changed on this point.

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22 If this were wrong then words "used in" in s.809L(2) ITA would be otiose since chattels used in the UK must be received in or brought to the UK.

23 EI Manual para 40302 provides:

> "If an employee receives earnings abroad which are used to purchase assets such as a car or a painting and the employee then brings the assets into the UK the earnings used to purchase the assets are regarded as remitted to the UK."

I would not wish to rely on that argument, and HMRC may not accept it. EN FB 2008 provides:

> 79. In some cases, a remittance basis taxpayer will make an accrued income profit on a transfer of securities, but will not receive consideration equal to the market value of the securities. ... In such cases the securities themselves are treated as deriving from the accrued income profits. *A charge will arise on the taxpayer when he, or some other "relevant person", either brings the securities to the UK (if they are held in bearer form)* or remits money or property deriving from the securities.

In practice this issue may not often arise as UK situate investments are unattractive: the income is subject to IT, gains subject to CGT, and IHT may also be a concern.

10.11.8 *Property used in the UK for the benefit of a relevant person*

The next way to satisfy remittance condition A is:

> *(f) Property is used in the UK for the benefit of a relevant person*

Funds can be said to be *applied* for the benefit of a person and it is suggested that "used for the benefit of a relevant person" has the same meaning.

The EI Manual provides at para 40302:

> *Paid in the UK*
> [1] Earnings are remitted to the UK if they are paid to the employee in cash in this country or if the employee's bank account here is credited with them. Employees may arrange to have earnings paid into offshore bank accounts to avoid this rule.
> [2] Money that is transmitted from the employer's bank in the UK to the employee's offshore bank is not treated as remitted here. It has been in the banking system all of the time; the employee did not have access to it.

The comment was considering the pre-2008 employment income remittance basis, but it is still correct under the ITA remittance basis (though the statement at [2] that the money has "been in the banking system" is layman's language.)[24]

10.11.9 *Situs of property for purpose of remittance condition A*

There are no statutory situs rules for income tax, so the rules of private international law apply. Thus money received in a UK branch of a foreign bank is remitted, but money received in a foreign branch of a UK bank is not remitted.[25] Money is remitted if received in:

(1) a UK account in the name of the taxpayer, and held by him beneficially; or
(2) a UK account held in the name of a third party who holds on trust for the taxpayer.

CGT has statutory situs rules. But it is considered that the effect of s.12(5) TCGA is to incorporate the ITA rules, so the CGT situs rules do not apply for the purpose of remittance condition A. If that were wrong, there would be a remittance under the CGT remittance basis whenever a UK resident

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24 *Foley v Hill* (1848) 2 HLC 28 at p.36 explains the relationship of banker/customer (and borrower/lender generally):

> "Money, when paid into a bank, ceases altogether to be the money of the principal ... ; it is then the money of the banker, who is bound to return an equivalent by paying a similar sum to that deposited with him when he is asked for it. The money paid into the banker's custody is money known by the principal to be placed there for the purpose of being under the control of the banker; it is then the banker's money; he is known to deal with it as his own; he makes what profit of it he can, which profit he retains to himself, paying back only the principal, ... or the principal and a small rate of interest ... The money placed in the custody of a banker is, to all intents and purposes, the money of the banker to do with it as he pleases; he is guilty of no breach of trust in employing it; he is not answerable to the principal if he puts it into jeopardy, if he engages in a hazardous speculation; he is not bound to keep it or deal with it as the property of his principal, but he is of course answerable for the amount, because he has contracted, having received that money, to repay to the principal, when demanded, a sum equivalent to that paid into his hands."

This is the classic exposition: see *Re Spectrum Plus* [2004] Ch 337 at [88]. However, "The difference between *commodatum* and *mutuum* – the loan to be returned and the loan to be repaid – was hardly seen. It is hardly seen today by the vulgar. 'My money at the bank', is a phrase in common use." (Maitland, *The Forms of Action at Common Law*, lecture V, 1909).

25 See 59.15 (Bank account).

foreign domiciliary:

(1) places sterling in a foreign bank account, as the account is regarded as UK situate for CGT;[26] or
(2) sells and leaves the purchase price outstanding, since the right to the purchase price is a UK situate asset under the CGT situs rules..

This is confirmed by s.809W(5) ITA which applies the CGT situs rules specifically for the purposes of s.809W(3) ITA.

Suppose T sells and leaves the purchase price outstanding as a debt. T receives property - the right to the purchase price – but where is it situate? If the purchaser/debtor is UK resident, the debt is UK situate, unless one takes specific steps in the documentation to avoid that. But if the purchaser/debtor is non-resident, the asset is not in principle UK situate.

10.11.10 *Non-UK company with UK asset – secondhand companies*

Suppose T acquires a non-UK company which holds a UK asset. If the UK asset is not enjoyed in specie by T or a relevant person, then Condition A is not satisfied. If the UK asset is (say) a house, which is occupied by T, then remittance condition A is satisfied. However, remittance condition B is not satisfied.

10.11.11 *Service provided in the UK*

The next way to satisfy remittance condition A is:

(e) a service is provided in the UK to a relevant person

The rule that a payment for services in the UK constitutes a remittance reverses the pre-2008 remittance basis rule. The ITA rule requires one to identify the place where services are provided, or at least whether they are provided in the UK. While in some cases this is practical, in other cases there is no obvious answer.

The connecting factors could be:

26 See 60.10 (Bank account).

(1) where the supplier is;
(2) where the customer is;
(3) where the work is done;
(4) where is the property to which the services relate.

It is suggested that the connecting factor should be where the work is done. This is consistent with the IT trading source rules.[27] In practice that will normally be where the supplier is. There will be cases where it is unclear how to decide where work is done, eg where a head supplier subcontracts to another, and this will require further investigation.

March 2009 Qs & As provides:

> **Q23:** It will be helpful to understand more fully the scope of sections 809L and 809W and the application of the exemption for services in circumstances where services have been provided which may only partially constitute a remittance. In the following, we assume that Condition B in section 809W relating to payment is satisfied. What is meant by "provided in" in section 809L(2)(b)? If a service provider engages with the Jersey resident trustees of a trust of which a UK resident but non-domiciled individual is a beneficiary and settlor and provides advice which is prepared and issued from the UK, but received and read in Jersey, it is not clear if this would be "a service provided in the UK."
>
> From the point of view of the trustees, the service is provided to them in Jersey although the providers of the service are in the UK.
>
> **A:** Whether the exemption for services in section 809W applies to the provision of a particular service will be determined by whether it meets condition A in section 809L(2)(b), namely whether it has been provided in the UK. The general rule is that, for the purposes of this condition, a service is regarded as being provided in the jurisdiction where the providers of that service are based. Advice which is researched, prepared and issued from the UK would therefore fall within the definition of "provided in the UK" irrespective of where the client might receive it.
>
> **Q24:** As part of providing advice to clients who have an international aspect to their affairs, a service provider may prepare advice in several different jurisdictions, which may then be issued from only one office, and therefore country, that being the office which has the main

27 See 14.9 (Services). Foreign property services relief assumes that a service which relates to property situate outside the UK may be a service provided in the UK. See 10.43 (Foreign property services relief).

> relationship with the client.
> **A:** In the case where an offshore service provider provides advice which has been prepared in several different jurisdictions, the same approach will need to be taken to determine whether the test in section 809L is met, and, because the advisors in your scenario are based in the UK, their service will be provided in the UK.

January 2009 Qs & As provides:

> **Q17:** On deemed remittances where are services provided? For example, if someone purchases an aeroplane ticket in New York for a flight from JFK to Heathrow, does the fact that the plane lands here mean that the entirety of the service is deemed to be provided in the UK and therefore if the plane ticket is purchased out of relevant foreign income it is deemed to be remitted?
> **A:** Yes, the payment for the flight to the UK is taxable as a remittance because a service is provided in the UK (Condition A of section 809L), the consideration for which is the individual's foreign income (Condition B of section 809L).

If Q17 is right, what about a flight from Heathrow to New York. Is that also a service provided in the UK? HMRC say that it is. The RDR Manual provides:

> *Example 3*
> Charlotte, a remittance basis user, purchases an air ticket using her foreign income. The ticket is to travel from the UK to Belgium. The ticket was purchased from an overseas company and payment made into the company's offshore bank account.
> Because part of the travel service was provided in the UK (the journey begins and ends in the UK) there is a remittance to the UK. The exemption provided for at ITA2007/S809W is **not** due as the service does not relate to property (see link to Chapter 4 below).

This is only right if "a service is provided in the UK" includes a service provided partly in the UK, which seems unlikely. It is considered that *neither* inward or outward international flights are "a service provided in the UK".

Basic planning is to use services outside the UK wherever possible, e.g. foreign investment advice, foreign accountancy services, foreign travel agencies, and foreign schools.

VAT has complex and somewhat arbitrary rules in s.7 VATA 1994 which determine where a service provided for VAT purposes, but there is no possible basis to incorporate those rules wholesale into the ITA remittance basis.

The VAT element on consideration for services is not itself a liability of the customer: it is just part of the consideration.[28] So payment of VAT on consideration for services is no different from payment of any other part of the consideration.

The last way to satisfy remittance condition A is:

> *(f) a service is provided in the UK for the benefit of a relevant person*

Do the words "for the benefit of" add anything? Is there a case where a service is provided for the benefit of a person but not to that person? Perhaps an example is where a parent P contracts with a school to educate his child C. The services are perhaps provided to P (who pays for them) but for the benefit of C.

10.12 Remittance condition B

Section 809L(3) ITA provides:

> Condition B is that—
> (a) the property, service or consideration for the service, is (wholly or in part) the income or chargeable gains,
> (b) the property, service or consideration—
> (i) derives (wholly or in part, and directly or indirectly) from the income or chargeable gains, and
> (ii) in the case of property or consideration, is property of or consideration given by a relevant person ... [29]

There are eight ways to satisfy remittance condition B. The first six[30] are:

(1) The property (in my terminology, the UK property)

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28 See *Glenrothes Development Corpn v IRC* [1994] STC 74.

29 Section 809L(3) continues with paras (c) and (d) which relate to debt remittances, considered separately below.

30 The remaining two relate to the debt remittance rules, which are considered separately below.

(a) is (wholly or in part) the income or gains,
(b) is derived property and is property of a relevant person.

(2) The consideration for the service (in my terminology, the UK service)
(a) is (wholly or in part) the income or gains, or
(b) is derived property and is property of a relevant person.

(3) The service:
(a) is the income or gains or
(b) derives from the income/gains.

10.12.1 *Property and consideration for service*

It is impossible to refer constantly to "the UK property and the consideration for the UK service" so I refer below to "the UK property" and leave the reference to "consideration for a UK service" to be read in, as the same points apply to both.

Remittance condition B is not satisfied unless the UK property either:

(1) is the foreign income or gains; or
(2) is derived from the foreign income or gains.

but in such a case, remittance condition C or D may apply.

If the UK property *is* the foreign income of gains, it does not have to meet the additional requirement that it is property of a relevant person. If the UK property is derived property, it does have to meet that additional requirement. Why the distinction? It is considered that if T transfers his income/gains to R, the funds cease to be the income/gains (instead in the hands of R the funds become derived property). That is, if the property *is* the foreign income or gains, the property must necessarily be property of the individual who is a relevant person, so it is not necessary to impose the requirement expressly.

Suppose:

(1) T gives foreign income to S (not a relevant person).
(2) S uses the money to buy property used by T.

Condition B is not satisfied: the purchased property is derived property but it is not the property of T or of any relevant person.

The question whether the UK property either *is* the foreign income/gains or is *derived from* the income/gains also matters for the purposes of s.809P

ITA (amount of income remitted).

We need to classify what the relevant person receives as (1) property or (2) a service or (3) neither. This is not always easy. Suppose T pays rent for use of a picture in the UK. Does he receive a service? It is thought not.[31] Does T receive property and if so what? He does not receive the picture, but it is arguable that he receives a contractual right, which is property. Or it may be that T makes a payment in respect of a relevant debt. A court is likely to hold that there is a remittance under one or other of these routes, though neither analysis is entirely trouble-free.

10.12.2 *Service derives from income/gains*

Next condition B is met if:

> The service
> (a) is the income or gain; or
> (b) derives from the income or gains.

I am unable to make sense of this. How can a service be (or derive from) income or gains? I think the references to "service" here are misconceived. Perhaps the drafter is considering services which constitute earnings or benefits in kind, or a disposal of an asset in consideration of services. In that case only para (b) is misconceived.

10.13 Property is the income or the gains

10.13.1 *What is the income?*

The question of whether the UK property is the income is straightforward if the income is pure income, such as dividends, interest or income distributions from trusts.

The question is less clear if the income consists of trading or rental income, since in this case the "income" is merely the result of a trading or property computation. The gross receipts of the trade or gross rents are not the income.

Suppose an individual borrows to purchase land and pays interest out of the rent. The income of the individual is the net profit (rent less interest),

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31 "Service" is widely defined for VAT, but that definition is not applicable here.

it is not the gross rent. So the payment of the interest out of the gross rent is not a remittance of the rental income. The income is the profit (if any) which is left after payment of the interest.

10.13.2 *What is the gain?*

The question of whether the property is the gains is problematic. What is the jurisprudential status of a gain? Inspectors Manual para 1567 published 9/95 provided:

> whilst the income content of any fund is a separate and distinguishable part of that fund, a capital gain is merely part of the whole proceeds of a disposal transaction that has no separate identifiable existence within those proceeds.

The Manual was correct to say that a capital gain has no separate identifiable existence. On one view, a gain does not exist even as "part of the whole proceeds". It is not a separate or separable item of property existing at all. A gain is merely the result of a computation. The proceeds of a disposal may be said to represent the gain, but they do not constitute the gain, just as gross trading receipts do not constitute the profits of a trade. On this analysis the proceeds of a disposal are not even derived from a gain, though the quantum of a gain depends on the quantum of the proceeds. But whatever the true jurisprudential status of a gain may be, I think the drafter has assumed that the proceeds of a disposal for full consideration should be regarded as consisting of (1) gain and (2) everything else (representing base cost and other exemptions) so the proceeds do include the gain.[32]

10.14 Derived property

Remittance condition B (and C and D) refer to property which derives (wholly or in part, and directly or indirectly) from the income or gains. I refer to this as "**derived property**".

The words "directly or indirectly" show that the drafter did not want the word "derives" to be construed very narrowly.

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32 The position is more difficult for sales at an undervalue: see 10.25.4 (sale of asset at undervalue).

10.14.1 *Enactment history*

Under the pre-2008 CGT and employment income remittance bases, tax was charged on sums received in the UK *in respect of* the foreign income. Under the ITA remittance basis, the sum must be *derived from* the income or gains. Is there any difference? It is impossible to say, since "in respect of" and "derived from" are both vague and context-dependent expressions but "derived from" is probably narrower.

Perhaps the change was made to give effect to the statement in the Inspectors Manual para 1564 published 9/95:

> Income is received in the UK if funds provided in the UK are derived from income arising overseas.

Perhaps there was no reason for the change: the drafter started with a blank sheet and chanced upon the expression "derived from" or perhaps considered it more in accordance with Plain English principles.

10.14.2 *Investment and re-investment*

Suppose T uses RFI to purchase assets. The purchased assets are derived from the RFI. If the purchased assets are sold and the proceeds re-invested is new assets, those new assets are derived from the RFI. The tracing process can continue for the lifetime of T.

10.14.3 *T gives funds to R*

Suppose T gives his income to R. The funds in the hands of R are not the income, but they are derived from the income. If R uses the income to purchase assets, the purchased assets are derived from the income, and (as above) the tracing process can continue indefinitely.

10.14.4 *T purchases asset or services for full consideration from R*

Suppose:

(1) T purchases an asset ("the purchased asset") from a relevant person ("R") for full consideration.
(2) T uses RFI to pay the purchase price.

It is considered that after the sale the purchase price in the hands of R is not the income and is not derived from the income. So if R remits the proceeds of sale, remittance condition B is not satisfied.[33]

Likewise if T provides services to R for full consideration, and T uses RFI to pay the fee. The fee in the hands of R is not derived from the RFI.

This must be the case, because if T uses RFI to purchase an asset from a company, at arm's length, T will often have no way of knowing whether the company is a relevant person, and T can hardly be expected to ask the company what it has done with his money. Whereas if T *gives* money to R, the request is not so unreasonable.

This view is was accepted in another context in *Cohen v Petch* [1999] STC (SCD) 207. Here:

(1) T borrowed funds from a building society and used them to purchase an asset from his mother.
(2) The mother immediately gave or lent the proceeds of sale back to the son.
(3) The son lent the money to a company.

The Special Commissioner said at p.211:

> I cannot overlook the fact that once the money had been borrowed [by] the taxpayer from the society it was paid to his mother and became her funds. Subsequently, three days later, the sum of £46,600 was returned to the taxpayer by his mother either in the form of a loan or as a gift. The funds, whether or not they are traceable in specie, were no longer the money borrowed from the society. They were funds lent or given by Mrs Daphne Cohen to her son. There was no longer any link between the money which the taxpayer eventually lent to the company and the money which he borrowed from the society.

33 There would be a remittance of the RFI if T remits the purchased asset to the UK. If my view is wrong, there would be a double charge to tax where the purchased asset represented RFI of R, that is, where:
(1) R receives RFI (R's income) and invests it in the asset (the purchased asset).
(2) T receives RFI (T's income) and uses it to purchase the asset.
Suppose T receives the purchased asset in the UK. T's income is remitted. But it would be surprising if R's income was also thereby remitted.

10.14.5 *T lends to R*

Suppose T receives RFI and lends it to an individual who is a relevant person ("R"). Are the funds in R's hands derived from the RFI? It is suggested that if the loan is on market terms, the answer is, no. R's funds are derived from R's promise to repay the loan. The argument is stronger if R has other funds to repay the loan.

If the loan is interest-free and repayable on demand, the position is arguably the same since the promise to repay is full consideration.[34] If the loan is a fixed-term loan at a low rate of interest then R's funds are derived partly from the RFI and partly from the promise to repay. However in a tax avoidance context, the court may disregard the consideration and treat the loan as a mere "conduit" as it did in *Harmel v Wright* 49 TC 149. This approach is easier to adopt in the case of an interest-free loan, but could be adopted even in the case of a loan on arm's length terms.

10.14.6 *T subscribes for shares in R Ltd*

Suppose T uses RFI to subscribe for shares in a company which is a relevant person ("R Ltd"). It is considered that the proceeds of the share subscription in R Ltd are derived indirectly from the income.

10.14.7 *T purchases shares in R Ltd (secondhand companies)*

Suppose T uses RFI to purchase the shares in R Ltd (a relevant person). R Ltd already owns assets. The assets of R Ltd are not derived property: they do not derive from the RFI.

10.14.8 *Purchase of interest in partnership*

Suppose T uses RFI to purchase an interest in a partnership. It is suggested that the partnership interest is derived from the RFI but the partnership assets are not. The partnership is not transparent for general law purposes.[35] If that is right then the purchase of an interest in a UK

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34 Contrast 51.6 ("Provide").

35 See 59.27 (Situs of partnership share).

partnership is a remittance (the receipt of a UK situate asset; the purchase of an interest in a foreign partnership is not a remittance; and the situs of the assets of the partnership is not relevant. The alternative view is that the IT and CGT statutory transparency rules apply here. In that case the purchase of an interest in any partnership (UK or not) is a remittance to the extent that the assets of the partnership are K situate. Since partnerships are commonly used as investment vehicles, this would be unworkable in practice.

10.14.9 *Receipt of cheque in UK*

Suppose T receives a cheque in the UK which if cashed would be foreign income. If the cheque is not transferable[36] the cheque is not derived property.[37] If the cheque is not sent abroad, but cashed here, there is still no remittance provided that the credit is made to an account abroad, not to a UK account.

10.14.10 *Borrowing on security of foreign income/gains*

Suppose T borrows on the security of his foreign income. Is the sum borrowed derived from the income? The borrowed money might be said to have derived from the income if (though only if) T could not have borrowed without giving that specific security. In this situation the debt remittance rules will apply[38] and that suggests that there would not be a remittance under general principles. So it is considered that borrowed money is derived from the promise to repay, not from the security, even if T could not have borrowed without giving that security.

In *West v Trennery* 76 TC 713, trustees held shares and borrowed money on the security of the shares. One question was whether the borrowed money was derived property for the purposes of s.77 TCGA (now

36 Cheques drawn on UK banks have generally been non-transferable since the Cheques Act 1992.

37 This continues the pre-2008 law. The Inspectors Manual provided:

> "A cheque representing income assessable under Schedule D, Case IV or V, which is received in the UK by or on behalf of the taxpayer but is sent abroad and credited to the taxpayer's overseas bank account is not a 'sum received in the UK'."

38 See 10.19.2 (Use as security for debt).

repealed). Section 77(8) TCGA at that time provided (somewhat tersely):[39]

> In this section "derived property", in relation to any property, means
> [a] income from that property or
> [b] any other property directly or indirectly representing
>   [i] proceeds of, or
>   [ii][of][40] income from,
>   that property
> [c] or income therefrom.

So the question was whether the borrowed money was property directly or indirectly representing the shares. Lord Millett said:

> 16. The final question is whether the Revenue are correct in contending that the [borrowed] moneys ... constituted derived property within the meaning of s 77(8) in relation to the Einkorn shares. There can be only one answer to this: of course they do. The [borrowed] moneys ... directly represented the proceeds of a mortgage of the Einkorn shares ... If the trustees ... had invested the moneys in stocks and shares, these would have indirectly represented those proceeds. It will be observed that I have equated the proceeds of a mortgage of property with the proceeds of the property itself. But the subsection does not refer to "the proceeds of a sale of that property", but to "the proceeds of that property"; and this covers any proceeds, whether sale or mortgage or otherwise howsoever, by which value is extracted from one property and transferred to another.[41]

It is considered that this case is of no relevance, since the statutory words on which the decision rests are not present in the remittance basis provisions.

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39 In 2006 the definition was amended with retrospective effect, only to be repealed in 2008.

40 The word "of" appears to be a grammatical error, but it does not matter.

41 Likewise Lord Walker said:

> "In my opinion the £770,000 [borrowed money] started off as derived property ..."

10.14.11 *Payment of debt*

Suppose:

(1) T borrows from L and receives the borrowed money.
(2) T uses RFI to repay the debt to L.

The borrowed money is not derived from the RFI. It is not derived from the RFI at the time of the borrowing. It cannot become derived from the RFI later when the debt is repaid. (The position could be different if the two steps formed part of a scheme and were carried out in very quick succession or if the debt was charged on the RFI.) The debt remittance rules would need to be considered.

It is considered that the funds in the hands of L on repayment of the loan are not derived from the RFI. They are derived from the debt, and (indirectly) from the money which L lent to T.

10.14.12 *Income from income/gains*

Suppose:

(1) T receives £1m ("original income").
(2) T invests the original income and receives £50k ("new income").

It is clear that the new income is not derived from the old income. Otherwise if T remits the £50k he will pay tax on the £1m.

10.14.13 *Gift to third person*

The position becomes more complex if a second individual is involved. Suppose:

(1) T gives income/gains to A (an individual who may or may not be a relevant person).
(2) A gives the fund to B (a relevant person).

It is suggested that the funds in the hands of B are derived property if steps (1) and (2) form an arrangement. If there is no connection of that kind between T's gift and the transfer to B, the funds in B's hands are not derived property. In particular, if B acquires the funds on the death of A, the funds are not derived property.[42]

If T gives income/gains to a trust and the trust appoints the fund to B, it is suggested that the same approach applies, but the two steps do form an arrangement because the trust is merely carrying out the intention of the settlor.

HMRC may not agree. March 2009 Qs & As provides:

> **Q9:** The scope of the concept of derivation needs to be clarified. It seems that it requires a tracing exercise to be carried out. It is not clear whether double derivation could arise, for example X gives assets representing income and gains to his spouse who then independently gifts those assets to a trust. At some point in the future the trustees may remit the assets to the UK for the benefit of a different relevant person. Must tracing be done through more than one relevant person?
> Does derivation require there to have been some conscious planning that the income and gains gifted or assets or funds representing them will be used for the benefit of a relevant person? If not, then it would seem to catch situations where remittance occurs without the knowledge of the donor. One example of this would be where, due to a change in circumstances/health of a relevant person many years after the gift, the donee remits funds to pay nursing home fees or medical expenses for that relevant person.
> **A:** The rules introducing the concept of tracing the source of untaxed foreign income and gains were introduced to prevent avoidance schemes which relied upon the recharacterisation of the original income or gains or upon a form of alienation where the enjoyment of the original income or gains continues to remain accessible to the individual whose income or gains they were originally. Therefore the tracing rules apply to look through a series of transactions, including through relevant persons, gift recipients and where there is a connected operation, to the original event from which the untaxed income or gains arose.
> The rules ensure that untaxed foreign income or gains cannot be transferred into, for example, capital gains which would attract tax at a lower rate than income on remittance to the UK, or into property which can be brought to the UK for the benefit of the individual who generated the original untaxed foreign income or gains.

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42 This view is supported a little by s.48(3C)(b) IHTA: see 44.10 (Purchased equitable interest).

10.15 Proceeds of divorce settlement

10.15.1 *Is a transfer on divorce for consideration?*

The starting point is to understand the family law background. A transfer in connection with divorce may be made:

(1) Pursuant to a court order
    (a) following a contested hearing; or
    (b) approving a settlement agreed by the parties.
(2) Without a court order but under an agreement between the parties (the transferee agreeing to seek no (or a lessor) court order in return for the transfer).

I assume in each case that the transfers are made bona fide, at arm's length and with no gratuitous intent. Are transfers of these kinds made for consideration? One might have thought that the answer was simply no, because (1) there is only "consideration" where there is a contract and (2) neither a court order nor an agreement between the parties constitute a binding contract.[43]

Accordingly in *G v G*[44] the High Court held that a transfer on a Court Order at a contested hearing (type (1)) was not made for consideration, so that CGT hold-over relief was available.

However in *Hill v Haines* [2008] Ch 412 the Court of Appeal held that a transfer pursuant to a Court Order on a contested hearing (type (1)) *was* made for consideration, for the purposes of s.339 Insolvency Act 1986.

Where does this leave *G v G* and CGT hold-over relief? Either it is overruled or else there are (at least) two concepts of consideration, in which case a transfer might be for consideration in one sense but not for consideration in the CGT sense. In that case one could never ask whether a transfer is made for consideration in the general, but only whether it is made for consideration in some specified sense of the ambiguous word.

Each view has some support in *Hill v Haines* (though they cannot both be right). Morritt C said

43 See *Aspden v Hildesley* 55 TC 609; *C&E Commissioners v Apple and Pear Development Council* [1985] STC 383; *IRC v Plummer* 54 TC 1 at p 57; *Unilever v. Smith* [2002] STC 113.

44 *G v G* [2002] EWHC 1339 [2003] Fam Law 14 [2002] 2 FLR 1143 at [43] accessible *www.kessler.co.uk*.

> [30] ... the fact that a transfer ordered by the court does not give rise to a payment of consideration so as to reduce the value of hold-over relief for capital gains tax [does not dictate] a conclusion that a property adjustment order must be regarded as made for no consideration.

In other words, "consideration" in the CGT code has a different meaning. But Rix LJ preferred the view that *G v G* was wrong.[45] Since Rix also agreed with Morritt, it is clear that he did not give a great deal of attention to this point. It is considered that the view of Morritt is to be preferred.. Rights under the Matrimonial Causes Act are not assets for CGT purposes: no gain arises when a spouse is awarded a capital sum. Accordingly, there is no "consideration" for CGT purposes. However that is a special case and a transfer on divorce is in principle made for consideration.

The CG Manual has not been revised after *Hill v Haines* but as some time has now elapsed since that decision became final it might be taken as a current statement of the HMRC view. Para 67192 provides:

> **Hold-over relief: Consideration [March 2006]**
> The disposal of an asset from one spouse or civil partner to the other in the circumstances described in CG67191 [that is, a disposal in the year after separation, which does not qualify for the CGT spouse exemption] is, where there is no recourse to the courts, usually made in exchange for a surrender by the donee of rights which they would otherwise be able to exercise to obtain alternative financial provision. In such cases we take the view that the value of the rights surrendered represents actual consideration of an amount which would reduce the gain potentially eligible for hold-over relief to nil. "Consideration" is not limited to money or money's worth.

After considering the case where there is gratuitous intent, which is so rare that it need not be considered here, the Manual continues:

45 At [81] "... As for *G v G*, the view expressed by Coleridge J at para 43 regarding potential consequences for the purposes of capital gains tax can hardly be regarded as authoritative in the absence of the revenue. As Coleridge J stated, his view that the wife gave no consideration for the shares transferred to her because "neither party has any 'rights'... cannot, of course, ultimately bind the Inland Revenue": he merely proceeded "on the footing" that business hold-over relief would be available to the husband. In doing so, he appears to have drawn an unnecessary inference from the decision of this court in the *Xydhias* case."

> However, in cases where there is recourse to the courts and a court makes an order
>
> - for ancillary relief under the Matrimonial Causes Act 1973 which results in a transfer of assets from one spouse to another, or
> - for property adjustment under the Civil Partnership Act 2004, or
> - formally ratifying an agreement reached by the divorcing parties or by the civil partners of a dissolved civil partnership dealing with the transfer of assets,
>
> we take the view that the spouse or civil partner to whom the assets are transferred does not give actual consideration, in the form of surrendered rights, for their transfer. A Court Order, made in these circumstances, reflects the exercise by the court of its independent statutory jurisdiction and is not the consequence of any party to the proceedings agreeing to surrender alternative rights in return for assets.
>
> This approach represents a change in the Revenue's prevailing practice, following consideration of judicial observations made in the case of *G v G* and applies with effect from 31 July 2002. Therefore, where assets are transferred between divorcing parties or between civil partners of a dissolved civil partnership by reason of a Court Order as described above and a claim for gift hold-over relief is made, or remains unsettled, on or after that date, the relief should not be restricted in accordance with Section 165(7) TCGA 1992 on the grounds that actual consideration has been given by the donee.

Thus in the HMRC view:

(1) An inter-spouse transfer which is not made under a court order is made for consideration.

(2) A transfer is made under a court order, including a consent order or *Tomlin* order is not made for consideration for it.

The distinction drawn between the two cases is very doubtful. It is considered that for CGT purposes there is no consideration in either case; but for other purposes (including the ITA remittance rules) there is consideration in both cases.

10.15.2 *Are the proceeds of divorce settlement "derived property"?*

Suppose T transfers RFI to W as part of a divorce settlement. It is suggested that the funds in the hands of W are not derived from the income. They are received for full consideration. If that is right, remittance condition B is not satisfied even if:

(1) W remits while still a relevant person (before decree absolute);
(2) W applies the funds for the benefit of relevant persons (eg the children or grandchildren of T under 18 while a relevant person.

However in case HMRC do not agree, W should not remit the funds until after decree absolute, by which time she has ceased to be a relevant person; and she should similarly not use the funds for the benefit of relevant persons (in relation to H) until after decree absolute. Then there is no remittance: see 10.20 (Becoming or ceasing to be a relevant person: conditions A and B).

As to debt remittance rules, see 10.18.10 (Debt imposed by law).

10.16 Debt remittance rules

I turn to the second part of remittance condition B. Section 809L(3) ITA provides:

> Condition B is that ...
> (c) the income or chargeable gains are used outside the UK (directly or indirectly) in respect of a relevant debt, or
> (d) anything deriving (wholly or in part, and directly or indirectly) from the income or chargeable gains is used as mentioned in para (c).

I refer to these rules as the "**debt remittance rules**".

The following conditions must be satisfied in order to have a debt remittance under condition B:

(1) A *relevant debt* (broadly, relating to UK property).
(2) Foreign income/gains used *in respect of* the debt.
(3) The income/gains are used *outside the UK*; however if the income/gains are used in the UK, there will normally be a remittance under the usual remittance rules.

There is of course no remittance if a relevant debt is paid out of a sum which does not constitute foreign income or gains or derived property; there is no remittance if foreign income or gains are used to satisfy a debt which is not a relevant debt.

The debt remittance rules replace the pre-2008 deemed remittance rules of the former ss.833, 834 ITTOIA. The current debt remittance rules are wider than the pre-2008 deemed remittance rules in several ways:

(1) The ITA rules apply to a taxpayer who is not ordinarily resident in the UK.
(2) The ITA rules apply to interest on a loan made outside the UK (which was not caught by the old rules).
(3) The ITA rules are not restricted to a debt for money lent.
(4) It is not necessary to satisfy the debt.

Debt is not defined. It is suggested that it includes any liability to pay money. If an individual takes a lease, the payment of rent is the payment of a debt. If the land is UK situate, the debt is a relevant debt.

10.17 Relevant debt

Remittance conditions B, C and D all use the term "relevant debt". Section 809L(7) ITA provides the definition. There are six categories of relevant debt:

> In this section "relevant debt" means a debt that relates (wholly or in part, and directly or indirectly) to—
> (a) property falling within subsection (2)(a) [UK property]
> (b) a service falling within subsection (2)(b) [UK service]
> (c) qualifying property dealt with as mentioned in subsection (4)(a),
> (d) a service falling within subsection (4)(b),
> (e) qualifying property dealt with as mentioned in subsection (5)(a), or
> (f) a service falling within subsection (5)(b).

To understand this one must read back in the words in the six cross-references. (a) and (b) relate to remittance condition A, (c) and (d) relate to remittance condition C, (e) and (f) relate to remittance condition D. When one reads in the words it is clear that para (f) is otiose: it only repeats para (d).

In para (e) "*Qualifying* property dealt with as mentioned in s.809L(5)(a)", the word "qualifying" is meaningless. The expression "qualifying property" is defined for remittance condition C but not for condition D.

In the following section I concentrate on identifying what is a relevant debt in cases where remittance condition A is satisfied. Unless remittance condition A (or the corresponding parts of conditions C or D) are satisfied, there cannot be a relevant debt.

10.18 Debt "relating" to property

"Relates" requires some nexus between the debt and the property received in the UK; exactly what that nexus is has been left to the courts to sort out.

The words "directly or indirectly" do not add any clarity; indeed I am not sure that it is altogether coherent to speak in the abstract of direct and indirect relationships, for "relates" requires a relationship and an indirectly relationship is a type of relationship. But the word "indirectly" shows that the drafter did not want the word "relates" to be construed very narrowly.

In the following discussion I normally just use the word "relate" and leave "directly or indirectly" to be understood.

10.18.1 *Debt relating to UK property in part*

If a debt relates partly to UK property, the entire debt is a relevant debt. The implications of this rule are discussed in para 10.24.4 (Apportionment rule for debt remittances). But HMRC do not agree. The RDR Manual provides an example where the facts (stripping out irrelevancies)[46] are as follows:

> *Example 4*
> K, a remittance basis user, borrows from an offshore bank
> - to pay UK school fees for her 14 year old daughter.
> - to pay for a summer school in France for the daughter.

46 The example (including its irrelevant detail) in full is as follows:
In August 2011 Karen, a remittance basis user, uses an interest-free [*sic*] overdraft facility on her Jersey bank account to pay UK school fees for her 14 year old daughter Lauren. She also uses the remainder of the facility to pay for Lauren to attend a summer school in France organised by a French university. Karen repays the overdraft from her relevant foreign earnings between August and November 2011.

> Karen repays the overdraft from her relevant foreign earnings in 2011-12.

The HMRC analysis is:

> There is a debt (the overdraft) which relates in part to a service provided in the UK (the schooling) to a relevant person (the daughter) – this part is a relevant debt. However part of the overdraft facility is not a relevant debt because it does not relate to a service provided to the daughter in the UK, but to a service provided in France.

The author has overlooked s.809L(7) ITA.

> The daughter therefore has taxable remittances in 2011-12 of the relevant foreign earnings used to service and repay the part of the overdraft that is a relevant debt.

10.18.2 *Borrowing money*

Suppose T borrows and receives money. The debt relates to the money. If T receives the borrowed money in the UK the debt relates to UK property. The residence of the lender is not relevant. A loan from a UK bank is not a relevant debt if the funds borrowed are received outside the UK.

If the borrowed money is initially received outside the UK condition A is not satisfied and the debt is not a relevant debt. If that money is later brought to the UK, condition A is then satisfied, and the debt at that time becomes a debt relating to UK property and so becomes a relevant debt. HMRC agree. FAQ Remittances (April 2008) states:

> Will the payment by a non-domiciled individual, out of foreign untaxed income, to an offshore bank to fund the interest due on a loan be treated as a taxable remittance *where the capital borrowed has been brought into the UK?*
> Yes, under new section [809L(3)(c)] the payment of the interest will be treated as a taxable remittance.

The RDR Manual provides an example where the facts (stripping out irrelevancies)[47] are as follows:

> *Example 5*
> In 2012/13 A, a remittance basis user, purchases a sculpture outside the UK. He borrows to fund this purchase,.
> A gives the sculpture to his wife W.
> W brings the sculpture to the UK.
> In 2013/14 A [implausibly] arranges with the bank that will transfer to them a painting held outside the UK, derived from relevant foreign earnings and tax-free capital.

The HMRC analysis is as follows:

> There is a debt (the loan from the bank) which relates to property (the sculpture) which is brought to the UK by a relevant person (W).
> The painting which derives, in part, from A's relevant foreign earnings, is used outside the UK in respect of this relevant debt.
> There is a taxable remittance in 2013-14, the tax year in which the painting is used to pay the relevant debt.
> The remittance occurs when the foreign income or gains are regarded as used in respect of the relevant debt (2013-14) not when the property is first used in the UK by a relevant person (2012-13). ...
> NB – for the purposes of this example assume there is no chargeable gain on the transfer of the painting to the bank.

Suppose T receives borrowed money in the UK and later takes it outside the UK. It is suggested that the debt no longer relates to property received in the UK so it ceases to be a relevant debt. However the contrary is arguable, that a debt which relates to property in the UK is for all time a relevant debt. If that were so, however then there are two odd

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47 The example (including its irrelevant detail) in full is as follows:
Ali, a remittance basis user, purchases a sculpture in Sweden in October 2012 (see earlier example). He takes out an interest-free [*sic*] loan with his US bank to fund this purchase, repayable within 1 year. In November 2012 he gives them to his wife as an anniversary gift.
She initially keeps it at her mother's home in Stockholm, but 6 months later in March 2013 Ali's wife decides to bring the sculpture to the UK to display in her UK garden. In October 2013 Ali arranges with the US bank that he will repay the loan by giving them an oil painting which is currently in his apartment in Miami, which he had purchased in May 2011, using his relevant foreign earnings, and some capital inherited from an uncle.

consequences: firstly the debt may relate to property which no longer exists; secondly, refinancing would solve the tax problem.[48] This suggests that my view is to be preferred.

Suppose T borrows and receives the borrowed money abroad but secures the debt on UK property. It is considered that one has to say that the debt does not relate to the UK property. Otherwise there would be a remittance when the debt is repaid, which is absurd.

10.18.3 *Borrowed money used to purchase asset*

Under a typical loan facility, T will borrow but he may not receive money: he may draw down the borrowing to pay for an asset, the money being paid directly to the vendor. In that case the debt relates to the asset which T has purchased. If the asset is UK situate, the debt relates to a UK asset and is a relevant debt.[49]

Suppose T borrows money, receives the money outside the UK and uses it to purchase an asset. The debt relates to the asset. If the asset is UK situate, the debt is a relevant debt. So it makes no difference whether the

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48 See 10.18.4 (Refinancing).

49 This seems straightforward, but for completeness HMRC agree. The RDR Manual provides:

> *Example 1*
>
> In May 2006 Katrina, a remittance basis user, borrows money from an overseas bank to buy shares in a UK company. This is a relevant debt as it relates to property (shares) in the UK which is for the benefit of a relevant person (Katrina).
>
> From 6 April 2008 any foreign income or gains that Katrina uses in respect of the loan, for example to service or to repay the loan, are taxable as a remittance.
>
> *Example 2*
>
> On 6 April 2015, Gary, a remittance basis user, borrows money from an overseas bank to buy an apartment in Solihull.
>
> The loan is a relevant debt because money is used in the UK, and it is respect of property (the apartment) which is used in the UK for the benefit of a relevant person (Gary).
>
> *Example 3*
>
> In October 2012 Robina, a remittance basis user, borrows money on a fixed-rate loan from an overseas bank to buy a car for Mark, a relevant person. Robina pays £x each month from 1 November 2012, making 24 monthly payments. She uses her foreign chargeable gains to make these repayments.
>
> The loan is a relevant debt because it is respect of property (the car) which is used in the UK by a relevant person (Mark).

loan is drawn down first or (which will be more usual) drawn down directly to pay for the asset.

Suppose:

(1) T borrows and uses the borrowed money to purchase a non-UK asset (“asset 1").
(2) T later sells asset 1 and uses the proceeds of sale to purchase a UK asset (“asset 2").

The debt relates to asset 1. It is considered that the debt does not necessarily relate to asset 2. The word “relates” requires more than just a historic tracing exercise. It is suggested that the debt relates to the UK asset if and only if steps (1) and (2) form part of an arrangement.

Suppose:

(1) T borrows.
(2) The borrowed funds (or proceeds representing them) are mixed with other funds.
(3) Some of the mixed funds are used to acquire a UK asset.

The ITA mixed fund regime does not apply and some commonsense tracing rules must be devised. But unless steps (1) to (3) form part of an arrangement, the debt does not relate to a UK asset.

10.18.4 *Borrowed money used to repay debt: refinancing*

Suppose:

(1) T borrows and uses the borrowed money to acquire UK property. The debt (“debt 1") is a relevant debt.
(2) T borrows more (“debt 2") and uses the borrowed funds to repay debt 1.

It is suggested that debt 2 is a relevant debt.

On the other hand suppose there is no UK asset at the time of step 2 (the refinancing), eg:

(1) T borrows and

(a) brings the borrowed money to the UK and later takes it out again; or
(b) uses the borrowed money to acquire UK property which is later sold and the proceeds taken out of the UK or
(c) spends the borrowed money in the UK.

In each case the debt ("debt 1") is a relevant debt.

(2) T borrows more ("debt 2") and uses the borrowed funds to repay debt 1.

It is considered that debt 2 is not a relevant debt.

Suppose:

(1) T borrows ("the first debt") and receives fund A.
(2) T borrows again ("the second debt") and uses the money borrowed on the second debt to repay the first debt. Thus T retains fund A.

It is considered that the second debt relates indirectly to fund A if the two steps form a single arrangement, but not otherwise.

10.18.5 *Borrowed money lent on to another person*

The position becomes more complex if borrowed money is lent on to another person. Suppose:

(1) T borrows money from a bank.
(2) T lends the borrowed money to A.
(3) A uses the money to acquire a UK asset ("A's UK asset").

In this case:

(1) T has a debt: the burden of the debt to the bank ("T's debt"). One needs to ask if it is a relevant debt.
(2) A has a debt: the burden of the debt to T ("A's debt"). One needs to ask if it is a relevant debt.
(3) T has an asset: the benefit of A's debt to T: one needs to ask if it is UK situate.
(4) A has an asset: "A's UK asset".

A's debt is a relevant debt: it relates to A's UK asset.

Is T's debt a relevant debt? T's debt relates to the benefit of A's debt. If the benefit of A's debt is a UK situate asset, then T's debt is a relevant debt. Let us assume this is not the case.

T's debt is also a relevant debt if (1) it relates (indirectly) to A's UK asset and (2) A is a relevant person in relation to T. It is suggested that T's debt does not relate to A's UK asset. This is clearly the case if steps (1) and (2) do not form an arrangement. If there is no connection of that kind between T's debt and the UK asset, the debt does not relate to the asset. But even if there is an arrangement, T's debt does not relate to A's UK asset, since T has another asset which relates to his debt. There is no scope for tax avoidance in this conclusion, since the relevant debt rules apply to A.

If my view is wrong, what would the position be if:

(1) T borrows from a bank and lends to A.
(2) A lends the proceeds of the borrowing to B.
(3) B uses the money to acquire a UK asset.

How many assets would T's debt relate to, and how could T keep track of them all?

10.18.6 *Borrowed money given to another person*

Suppose:

(1) T borrows money from a bank.
(2) T gives the borrowed money to A.
(3) A uses the money to acquire a UK asset ("A's UK asset").

In this case:

(1) T has a debt: the burden of the debt to the bank ("T's debt"). One needs to ask if it is a relevant debt.
(2) T has an asset: the benefit of A's debt to T: one needs to ask if it is UK situate.
(3) A has an asset: "A's UK asset".

Is T's debt a relevant debt? T's debt is a relevant debt if (1) it relates (indirectly) to A's UK asset and (2) A is a relevant person in relation to T.

It is suggested that T's debt relates to A's UK asset if and only if steps (1) and (2) form an arrangement. If there is no connection of that kind between T's debt and the UK asset, the debt does not relate to the asset.[50]

10.18.7 *Borrowed money used to buy secondhand company*

Suppose T borrows and buys all the shares of a company which owns a UK asset. The debt relates to the shares. At first sight it may seem likely that the debt also relates to the UK asset. But note that if T uses foreign income to purchase the shares, the income is not remitted. That being the case, it would be anomalous if there were a remittance if T borrows to purchase the shares and then uses foreign income to pay the debt. So the debt should not be regarded as a relevant debt: the debt does not relate to the assets of the company. One does not lightly pierce the corporate veil.

10.18.8 *Borrowed money used to buy partnership interest*

Suppose T borrows and buys an interest in a partnership which owns a UK asset. It is suggested that the debt does not relate to the UK asset.[51]

10.18.9 *Interest on debt*

Section 809L(8) ITA defined "relates" to include interest on a debt:

> *For that purpose, the reference to a debt that relates to property or a service includes a debt for interest on money lent, where the lending relates to the property or service.*

In the 2008/09 edition of this work I said:

> This only applies to a debt for interest *on money lent*. If T contracts to purchase an asset, the purchase price payable by installments with interest, the interest is not interest on money lent; so by implication the debt for the interest is not a relevant debt. Otherwise s.809L(8) is otiose. Of course a charge only arises if an individual uses foreign income or gains to pay the interest. If interest allowable in computing rental income

50 Contrast 10.14.13 (Gift to third person).

51 See 9.11.8 (Purchase of interest in partnership).

is paid out of rent, there is no remittance.[52]

The FA 2009 repealed s.809L(8). The 2009 Budget Notes omit to mention this reform and EN FB 2009 gives no explanation.

10.18.10 *Debt imposed by law*

Debts may be imposed by law. Court orders on divorces are not relevant debts (they do not relate to UK property) and indeed the obligation is not a "debt". So the debt remittance rules do not apply. Similarly, fines imposed by the courts do not in principle relate to UK property.

There might, however, be a remittance under ordinary principles when the debt is paid.

A tax liability relating to foreign income or gains is not a relevant debt, but it might be argued that a tax liability relating to UK income or gains, or remitted RFI and foreign gains, does relate to UK property.

10.18.11 *Borrowing by relevant person (not the individual)*

Suppose:

(1) A relevant person ("R" - not the individual) borrows.
(2) R receives the funds in the UK (so the debt is a relevant debt).
(3) The individual uses foreign income or gains to pay the debt or interest.

This is in principle caught. That applies even to pre-2008 debts. There is transitional relief if pre-2008 income/gains are used to repay the debt (wherever made).[53] However, transitional relief for pre-2008 debts[54] does not apply in this case.

10.19 "Use in respect of" a relevant debt

Condition B is satisfied only if income/gains are used in respect of the relevant debt.

52 See 10.13 (Property is the income or the gains).
53 See 9.7 (Relevant person transitional rules for pre-2008/09 income and gains).
54 See 9.44 (Transitional rules for pre-2008 loans).

Use “in respect of” a debt requires some nexus between the use and the debt; exactly what that nexus is has been left to the courts to sort out. The words “directly or indirectly” do not add any clarity. Indeed I am not sure that it is altogether coherent to speak in the abstract of use directly or indirectly in respect of a debt, for use indirectly in respect of a debt is use in respect of a debt. But the word “indirectly” shows that the drafter did not want the words “in respect of” to be construed very narrowly.

In this section I sometimes refer simply to a debt rather than a relevant debt, i.e. I assume the debt is a relevant debt.

If foreign income/gains are used to pay a relevant debt, this is a remittance under the debt remittance rules: money used to pay a debt is used in respect of a debt.

10.19.1 *Payment of interest*

If foreign income/gains are used to pay interest on a debt, I would have thought that the sum is used in respect of the debt, but the point is made expressly. Section 809L(9) ITA was amended by the FA 2009 from 22 April 2009. It now provides:

> The cases in which property (including income or chargeable gains) is used in respect of a debt include cases where the property is used to pay interest on the debt.

From 6 April 2008 to 21 April 2009, s.809L provided:

> *The cases in which income or chargeable gains are used in respect of a debt include cases where income or chargeable gains are used to pay interest on the debt.*

10.19.2 *Use as security for debt*

Suppose:

(1) foreign income/gains are charged as security for a debt and
(2) the loan is only made because of that charge.

It appears at first sight that this is use in respect of a debt.[55] This appears to be the HMRC view. The RDR Manual provides:

> Where foreign income and gains are used as collateral on a loan and the borrowed money is brought to the UK or otherwise used for a purpose to which ITA2007/s809L applies, the foreign income and gains may be regarded as used "in respect of" the relevant debt, so there may be a taxable remittance at this point.

But suppose:

(1) T holds £3m foreign income outside the UK.
(2) T borrows £1m on the security of the foreign income and receives the £1m in the UK, so the £1m debt is a relevant debt.

If the £3m is used in respect of a relevant debt, is regarded as remitted[56] the tax would normally exceed the sum remitted. Perhaps one should say that only one third of the foreign income is "used". That gives the right result but it is a far-fetched interpretation of the word "used". Or perhaps the foreign income is not "used" at all.

Example 1
T holds £100,000 unremitted foreign income in an offshore bank account. T borrows £100,000 by overdrawing another account at the same bank and remits this to the UK.

It is considered that Condition B is not satisfied because T has not "used" the foreign income.

Example 2
As example 1 but T expressly agrees that the bank should have a right of set-off.

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55 It is accepted that securities charged for the purposes of a Lloyds underwriter are "used in the business" for the purposes of BPR, s.110 IHTA 1984.
This view gives a continuity with the pre-2008 law, see s.834 ITTOIA but that counts for nothing as we have an entirely new regime.

56 See 10.24 (Amount remitted).

It is considered that T has not "used" the foreign income, unless the bank only lends because T has agreed the right of set-off.

Example 3
As example 1, but T agrees not to withdraw the accumulated foreign income while the debt is outstanding.

This amounts to a lien and condition B is arguably satisfied if the loan would not have been made without the lien.

Example 4
T borrows £100,000 and deposits foreign income of £100,000 as security. As time passes, (say) £50,000 new income accrues on the deposit.

Condition B is not satisfied in relation to this £50,000 new income as it has not been "used".

Suppose the charge was made before 2008, and a further debt was drawn down by a fresh borrowing after 2008. It is suggested that the funds were "used" before 2008 and were not "used" again subsequently.

10.19.3 *Back-to-back loans*

Suppose:

(1) T deposits foreign income/gains in a bank ("T's deposit").
(2) T borrows from the bank ("the relevant debt").
(3) No interest is paid on T's deposit and only a small rate if interest is paid on the borrowing.

It is suggested that the income/gains deposited is used in respect of the relevant debt. On the other hand, if commercial interest rates are paid on the deposit and the borrowing, the deposited funds are not used in respect of the debt.

10.20 Becoming or ceasing to be a relevant person: conditions A & B

A person may be a relevant person at one time and not at another time. For instance, a child ceases to be a relevant person on becoming 18; a person becomes a relevant person on marriage or cohabitation and ceases to be a relevant person on divorce or separation. A company becomes a relevant person in relation to T if T becomes a participator in the company.[57]

The statute gives no guidance to the application of conditions A and B in this situation. We need to find the answer as best we can in the words of the statute.

10.20.1 *Condition A*

Section 809L(2) ITA provides:

> Condition A is that—
>
> (a) money or other property is brought to, or received or used in, the UK by ... a relevant person...

For present purposes there are three ways of satisfying condition A: property must be (i) brought or (ii) received or (iii) used in the UK by a relevant person. Property is *brought* or *received* in the UK at a particular moment, and it is considered that the person must be a relevant person at that moment.

Suppose:

(1) T uses RFI to make a gift of an asset to S (not a relevant person). S brings or receives the asset in the UK. There is no charge at the time of the gift or of the receipt in the UK.
(2) Later, S becomes a spouse or cohabitee, and so becomes a relevant person. There is no charge at that time.

Likewise if:

(1) T uses RFI to make a gift of an asset to R (a relevant person). R does not remit the asset to the UK. There is no charge at this time.
(2) Later, R ceases to be a relevant person, and subsequently brings or receives the asset in the UK. There is no charge at that time.

57 Contrast 10.21 (Debt becoming or ceasing to be a relevant debt).

HMRC agree. The RDR Manual provides an example where the facts (stripping out irrelevancies)[58] are:

> In 2013 W uses foreign chargeable gains to purchase a motorcycle in Paris
> W gives the asset to her husband H. H keeps the bike at his French apartment. [So there is no remittance at this time].
> Subsequently, H and W divorce, and H moves from their home [ie H ceases to be a relevant person].
> In 2017 H brings his bike to the UK.

The relevant part of HMRC analysis is as follows:

> H and W were married and so H was a relevant person in 2013 when W gave him the motorcycle; he could not therefore have been a gift recipient (see Condition C – Gift recipients cannot be relevant persons).

More analytically, condition C is not satisfied.

> By 2017 they have divorced so H is not a relevant person when he brings in the motorcycle [to the UK] for S to use.

More analytically, condition A is not satisfied here because H is not a relevant person when he brings the asset to the UK.

10.20.2 *Condition B*

Condition B provides (in part):

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58 The example (including its irrelevant detail) in full is as follows:
Example 5
Caroline is a remittance basis user. In August 2013 she realises some foreign assets and so makes some foreign chargeable gains. She uses all the proceeds (and so uses all these gains) to purchase a motorcycle in Paris which she gives to her husband Joel. It is registered in his name. Joel keeps the bike at his French apartment. A few years' [*sic*] later Caroline and Joel divorce, and Joel moves from their home in Liverpool to Manchester.
In September 2017 Joel and Caroline's 16 year old son, Joseph wants to learn how to ride a motorcycle, so Joel imports his bike from Paris to his Manchester home for Joseph to use.

> Condition B is that—
> (b) the property, service or consideration [received in the UK]—
> (i) derives (wholly or in part, and directly or indirectly) from the income or chargeable gains, and
> (ii) in the case of property or consideration, is property of or consideration given by a relevant person ...

It is considered that the requirement in (b)(ii) is met only if the person is a relevant person at the time that condition A is met (ie at the time that the property is received/brought/used in the UK). HMRC agree. The RDR Manual provides an example (already discussed above in connection with condition A.) The facts (so far as relevant) are as set out above with one additional fact:

> The motorcycle is used in the UK by C who is a minor child of W (a relevant person).

The HMRC analysis is as follows:

> Here, property has been provided in the UK (the motorcycle) for the use of a relevant person (C) and the property derives directly from W's foreign chargeable gains.

More analytically, condition A is satisfied.

> However the motorcycle is the property of H, who is not a relevant person [at the time that the property is used by the relevant person], so there is no taxable remittance for W.

More analytically, condition B is not satisfied here because H is not a relevant person when the asset is used by the relevant person, C.

To drive the point home, the RDR Manual gives another example making the same points on somewhat far-fetched facts. So far as relevant[59] the

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59 The example in full (including all its irrelevant detail) is as follows:
Example 6
In 2011, while visiting New York, Ros, a UK resident remittance basis user, purchases several art prints by H Marecus, an international artist. Ros uses her relevant foreign income to make the purchase. She gives them to her daughter Rachael, who is at that time living and studying in the US, as a 16th birthday present in February 2011. Rachael returns to the UK in May 2011, but leaves the prints at her uncle's New York apartment.
In June 2016 Rachael's 3 year old daughter Abigail decides to start singing lessons

facts are:

> In 2011 W uses RFI to purchase prints retained outside the UK.
> W gives the prints to her daughter D who is age 16 and so a relevant person. D retains the prints outside the UK [so there is no remittance].
> D ceases to be a relevant person on becoming 18 but in that year (bucking statistics) D has a child GD (who is a relevant person in relation to W).
> In 2016 D enters into an (implausible) agreement under which she transfers the prints to the mother of a singing teacher outside the UK in consideration of the teacher giving singing lessons to GD (age only 3) in the UK.

The HMRC analysis is as follows:

> A service has been provided in the UK (the singing lessons) for the benefit of a relevant person (GD) and the consideration for the service (the print) derives from W's RFI.

More analytically, condition A is satisfied.

> However the consideration is given by D, who is not a relevant person [at the time that condition A is satisfied] and so W has not made a taxable remittance of her relevant foreign income. Rachael is 21 years old and so is not a relevant person in June 2016 when she gives the prints in consideration for a service.

More analytically, condition B is not satisfied.

> Note – D was 16 years old and so is a relevant person in February 2011 when her mother gave her the prints (see also Condition C – Gift recipients cannot be relevant persons).

More analytically, condition C is not satisfied.

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in Newcastle. The singing teacher's mother is a collector of Marecus prints, so the teacher agrees with Rachael to accept one of the prints in exchange for the lessons. Rachael arranges for her uncle to send the print from New York directly to the singing teacher's mother in California.

The rule of when one applies the relevant person test may work in favour of HMRC. Suppose:

(1) T uses RFI to make a gift of an asset to S (not a relevant person). There is no charge at this time.
(2) S becomes a relevant person, and subsequently remits the asset to the UK. There is a remittance charge at that time.

HMRC agree. The RDR Manual provides an example where the facts (stripping out irrelevancies)[60] are:

> In 2010 T uses RFI to purchase a clock outside the UK.
> T immediately gives the clock to S (not a relevant person) and it is kept outside the UK.
> S, not being a relevant person, is a gift recipient.
> In 2014, T marries S. S becomes a relevant person and ceases to be a gift recipient at this time.
> Subsequently, S brings the clock to the UK.

The HMRC analysis is as follows:

> As S is no longer a gift recipient Condition C is not relevant.
> However as S is now [in 2014] a relevant person there is a taxable remittance chargeable on T when S imports the clock, under Conditions A and B. This is because
> [1] property (the clock) has been brought to the UK by a relevant person (S) [ie condition A is satisfied] and

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60 The example (including its irrelevant detail) in full is as follows:
"In June 2010 Sam, a remittance basis user, uses £8,000 of her relevant foreign income to make an overseas purchase of an antique clock from a dealer in Denmark. Sam immediately makes a gift of an antique clock to Chris and Jo, who at that time are living in Denmark. The clock is kept at Chris's family home in Copenhagen.
Chris, not being a relevant person, is a gift recipient.
Two years later Jo and Chris split up, and in July 2014, Sam and Chris marry. Chris ceases to be a gift recipient at this time.
In October 2014 Chris brings the antique clock to the UK to the house that is shared with Sam."
The example as published is defective in that it must be assumed (though this is not stated) that Chris gave his interest in the clock to Jo (or perhaps the gift was to Jo and not to Jo and Chris).

[2] that property derives from T's RFI and the property is property of a relevant person (S) [ie condition B is satisfied]

So far we have considered property brought to or received in the UK. That can happen only at a particular moment. On the other hand, property can be *used* in the UK over a period of time. Suppose:

(1) Year 1: T uses RFI to make a gift of an asset to S (not a relevant person). S uses and continues to use the asset in the UK eg she buys a house which she occupies. There is no charge at the time of the gift or at the time of the use.
(2) Year 2: S becomes a spouse or cohabitee, and so becomes a relevant person. She continues to use the property.

Is there a charge in year 2 when S becomes a relevant person? It would be strange if there were a difference between this case and the case of receipt in the UK. It is tentatively suggested that the answer is, no.

10.20.3 *Third persons*

The position becomes more complicated when a third person is involved. Suppose:
(1) T gives RFI to his spouse W.
(2) There is a divorce and W ceases to be a relevant person.
(3) W transfers the RFI to a trust under which a minor child of T is a beneficiary. The trustee is a relevant person in relation to T.
(4) The trustee transfers the funds to the minor child who receives them in the UK.

Condition B appears to be satisfied since at the time of the receipt in the UK the funds are the funds of a relevant person.

10.21 Debt becoming or ceasing to be a relevant debt

A debt may be a relevant debt at one time and not at another time. Condition B is (in short) that income is used in respect of a relevant debt. It is considered that the debt must be a relevant debt at the time the income is used.

Suppose:

(1) Year 1: T borrows and receives the borrowed sum offshore.
(2) Year 1: T uses RFI to pay the interest (use in respect of the debt).

In year 1 condition B is not satisfied as the RFI is not used in respect of a relevant debt.

(3) Year 2: T remits the borrowed sum to the UK.

In year 2 the debt becomes a relevant debt, but it is considered that the RFI used to pay interest in year 1 does not become remitted at that time. But if further RFI is used to pay more interest in year 2, that RFI satisfies condition B.

10.22 Remittance condition C

Section 809L(4) ITA provides:

> Condition C is that qualifying property of a gift recipient—
> (a) is brought to, or received or used in, the UK, and is enjoyed by a relevant person,
> (b) is consideration for a service that is enjoyed in the UK by a relevant person, or
> (c) is used outside the UK (directly or indirectly) in respect of a relevant debt.

10.22.1 *Enjoyment by a relevant person*

The requirements in (a) and (b) are similar but not the same as remittance condition A because the property must be *enjoyed* by a relevant person.

The key terms here are gift recipient and qualifying property. Section 809N ITA provides the definitions and other supplementary provisions for condition C. Section 809N(1) ITA provides:

> This section applies for the purposes of determining whether or not income or chargeable gains of an individual are remitted to the UK by virtue of condition C in section 809L(4).

10.22.2 *Gift recipient*

Section 809N(2) ITA provides:

> A "gift recipient" means a person, other than a relevant person, to whom the individual makes a gift of money or other property that—
> (a) is income or chargeable gains of the individual, or
> (b) derives (wholly or in part, and directly or indirectly) from income or chargeable gains of the individual.

Strictly one should not use the term "gift recipient" in the abstract. A gift recipient can exist only *in relation to an individual (the donor)*. But where the context is clear it is permissible simply to refer to a gift recipient.

A relevant person cannot be a gift recipient. So in practice gift recipients will be individuals who are not members of the individual's close family – for instance parents, adult children, friends and more distant relatives. (Trusts and companies will generally be relevant persons and where they are not, it is unlikely they would or properly could enter into a transaction caught by condition C.)

Section 809N(5) ITA extends "gift" to include disposals at an undervalue:

> The individual "makes a gift of" property if the individual disposes of the property—
> (a) for no consideration, or
> (b) for consideration less than the full consideration in money or money's worth that would be given if the disposal were by way of a bargain made at arm's length;
> but, in a case falling in para (b), the individual is to be taken to make a gift of only so much of the property as exceeds the consideration actually given.

In the phrase "full consideration in money or money's worth *that would be given if the disposal were by way of a bargain made at arm's length*" do the italicised words add anything? It is thought not; these words are otiose but they do no harm.

Section 809N(6) ITA is intended to widen this:

> A reference to the individual making a gift of property includes a case where—
> (a) the individual retains an interest in the property, or
> (b) an interest, right or arrangement enables or entitles the individual to benefit from the property.

I am unable to make sense of this. The wording is loosely based on s.102A FA 1986 but the context there is different, and s.102A is itself obscure, so that does not shed any light on the matter. Perhaps it is meaningless.

Suppose T makes an interest-free loan to Q. The transaction is for full consideration so it is not a gift within s.809N(5). A lender in principle has no interest in the money lent so s.809N(6)(a) does not apply. A loan does not entitle T to benefit from the money lent. Q may use that money for himself. It is considered that the loan does not enable T to benefit from the money lent, so Q is not a gift recipient.

If T makes a gift to G, and G gives the property to H, H is not a gift recipient in relation to T.

If T makes a gift to a trust, and the trust appoints the property to B, B is not a gift recipient, as T has not made a gift to B.

10.22.3 *Meaning of "qualifying property"*

Section 809N(7) ITA defines "qualifying property". There are three categories of qualifying property:

> "Qualifying property", in relation to a gift recipient, is—
> (a) the property that the individual gave to the gift recipient,
> (b) anything that derives (wholly or in part, and directly or indirectly) from that property, or

Para (a) and (b) are what one would expect, but the definition goes on to include something much wider:

> (c) any other property, but only if it is dealt with as mentioned in section 809L(4)(a), (b) or (c) by virtue of an operation which is effected—
> (i) with reference to the gift of the property to the gift recipient, or
> (ii) with a view to enabling or facilitating the gift of the property to the gift recipient to be made.

Section 809N(8) ITA is intended to widen this:

> In subsection (7)—

> (a) the reference in para (b) to anything deriving from property, and
> (b) the reference in para (c) to other property,
>
> includes a thing,[61] or property, that does not belong to the individual but which the individual is enabled or entitled to benefit from by virtue of any interest, right or arrangement.

This is misconceived. Qualifying property will not belong to the individual because it has been given to the gift recipient, so it is not necessary to say that property includes property not belonging to the recipient. Here, as in s.809N(6), the drafter's desire to achieve the widest possible generality, and avoid any possible gaps in the legislation, has led to incoherence.

10.22.4 *Exceptions*

Section 809N(9) ITA provides three exceptions to remittance condition C:

> Enjoyment by a relevant person of property or a service is to be disregarded in any of these cases—
> (a) if the property or service is enjoyed virtually to the entire exclusion of all relevant persons;
> (b) if full consideration in money or money's worth is given by a relevant person for the enjoyment; or
> (c) the property or service is enjoyed by relevant persons in the same way, and on the same terms, as it may be enjoyed by the general public or by a section of the general public.

Para (a) and (b) are based on IHT GWR provisions. Para (c) concerns charitable or public gifts, but it is hard to see that it is needed.

Para (b) is the most important of the three exceptions: I refer to it as "**the full consideration exemption**".

10.22.5 *Time of remittance*

Section 809L(6) ITA provides:

61 The reference to a "*thing or* property" is meaningless. What non-property "thing" could there be?

> In a case where subsection (4)(a) or (b) or (5)(a) or (b) applies to the importation or use of property, the income or chargeable gains are taken to be remitted at the time the property or service is first enjoyed by a relevant person by virtue of that importation or use.

10.22.6 *HMRC examples*

What does remittance condition C catch which is not already caught by conditions A and B?

The RDR Manual provides a simple example where the facts (stripping out irrelevancies)[62] are:

> T gives chargeable gains to his sister G (a gift recipient).
> (a) G gives half of the money to T's wife W (a relevant person) in the UK.
> (b) G uses half of the money to buy a car which W uses in the UK.

Condition C is satisfied in case (a) and (b). (Condition B would not be satisfied in case (b) because the property is not property of a relevant person. Would Condition B be satisfied in case (a)?)

62 The example (including its irrelevant detail) in full is as follows:
"*Example 1(a)*
In May 2015 Klimt, a remittance basis user, gives some of his foreign chargeable gains for that year to his sister Helena, a gift recipient.
In October 2016 Helena transfers half of this money to the UK and gives it to Klimt's wife.
The qualifying property here is the money that Klimt gifted to Helena. That qualifying property is used in the UK and is enjoyed by a relevant person (Klimt's wife). The use of the gift means there is a taxable remittance on Klimt.
Example 1(b)
In May 2015 Klimt, a remittance basis user, gives some of his foreign chargeable gains for that year to his sister Helena, a gift recipient.
In October 2016 Helena uses half of this money to buy a car in the UK which she makes available to Klimt's wife to use.
The qualifying property here is the car, which derives from the money that Klimt gifted to Helena. That qualifying property is used in the UK and is enjoyed by a relevant person (Klimt's wife). The use of the gift means there is a taxable remittance on Klimt."

Then the RDR Manual provides a more challenging example. The facts (stripping out irrelevancies)[63] are:

> T gives RFI to his aunt G (a gift recipient) on the agreement that G will licence T's wife W to use a property in the UK without charge.
> Several months later G grants a licence to W accordingly.

If the "gift" of the RFI is consideration for the use of the land then there is a straightforward remittance under remittance conditions A and B. It is assumed (somewhat implausibly) that the transfer is not for consideration. The HMRC analysis is as follows:

> The house cannot be said to "derive from" the income or gains.

More analytically, condition B is not satisfied. But condition C is satisfied:

> The house is "other property" used in the UK and enjoyed by a relevant person (W). As the operation which brought the house within Condition C was done with reference to the gift or to enable or facilitate the gift it is qualifying property and Condition C is met.
> There is a remittance and tax is chargeable on T. The amount of the remittance is determined by s809P(11)(c).

Suppose the order of transactions was reversed:

> (1) G grants a licence to W to use a property in the UK.
> (2) Later T gives RFI to G.

Condition C is not satisfied at stage (1) since G is not at that point a gift recipient. At stage (2) G becomes a gift recipient but condition C does not become satisfied.

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63 The example (including its irrelevant detail) in full is as follows:

> Linda's husband's family has owned a holiday house in Scotland for many years. In February 2012 Adam, a remittance basis user transfers some of his foreign income and gains to his aunt, Linda, the gift recipient, which she uses to book herself on an around-the-world cruise. Adam gives the money to Linda on the agreement that Linda will provide his wife Clare, a keen painter, with access to the Scottish property.
> Several months later Linda provides Clare with an agreement saying that she can use the Scottish house, for which Clare pays nothing.

The last HMRC example is slightly contrived, in order to illustrate the relevant debt rule in application to remittance condition C. The facts (stripping out irrelevancies)[64] are:

> T purchases non-UK shares using RFI.
> T gives the shares to his brother G, a gift recipient.
> G borrows to purchase furniture.
> T uses the furniture in the UK.
> G uses the shares to repay the loan.

The HMRC analysis is as follows:

> T has made a gift of property derived from his foreign income (the shares) to G, a gift recipient. The shares are thus qualifying property of a gift recipient.
> The loan taken out by G to purchase the furniture is a relevant debt because it relates to property (the furniture) brought to the UK for the benefit of a relevant person (T). T benefits because he uses the furniture.
> The qualifying property (the shares) of G (a gift recipient) is used outside the UK in respect of this relevant debt. There is a remittance under Condition C.

Suppose T gives RFI to his adult son S (not a relevant person) and S uses it to buy the house in the UK in which T lives. This is not caught by remittance condition B. (The house is derived property, it derives from the RFI but it is not property of a relevant person.) So it can be caught by remittance condition C under s.809N7(a)(b).[65] The drafter was also concerned that:

(1) T makes a gift to G (say, an adult son);

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64 The example (including its irrelevant detail) in full is as follows:
Fraser, who is a remittance basis user, purchases some non-UK shares in January 2012, using his foreign income and gains. Fraser makes a gift of these shares to his brother, Victor, a fashion designer.
In March 2012 Victor takes out a loan with an offshore bank to purchase a designer table and chairs. Victor brings these table and chairs to the London town house that he and his brother Fraser inherited jointly from their father, and where they both now live. Fraser regularly entertains clients and friends at the house.
Victor uses some of the shares and bonds to pay off the loan.

65 See 10.26 (Purchase of family home).

(2) G makes a gift of other property to T.

This can be caught by s.809N(7)(c).

10.22.7 *Transitional rules: pre-2008 income/gains*

Para 87 Sch 7 FA 2008 provides:

> Section 809N of ITA 2007 (section 809L: gift recipients, qualifying property and enjoyment) has effect in relation to an individual's income and chargeable gains for the tax year 2007-08 or any earlier tax year as if—
>
> (a) the reference in subsection (2) to a relevant person were to the individual,
> (b) subsections (3) and (4) were omitted, and
> (c) the references in subsection (9) to a relevant person, all relevant persons, or relevant persons were to the individual.

Amended as para 87 requires, s.809N reads:

> **809N Section 809L: gift recipients, qualifying property and enjoyment**
> (1) This section applies for the purposes of determining whether or not income or chargeable gains of an individual are remitted to the UK by virtue of condition C in section 809L.
> (2) A "gift recipient" means a person, other than ~~a relevant person~~, <u>the individual</u> to whom the individual makes a gift of money or other property that—
> (a) is income or chargeable gains of the individual, or
> (b) derives (wholly or in part, and directly or indirectly) from income or chargeable gains of the individual.
> (3)(4) - [deleted]
> (5) - (6) [defining "makes a gift of" property - as before]
> (7) "Qualifying property", in relation to a gift recipient, is—
> (a) the property that the individual gave to the gift recipient,
> (b) anything that derives (wholly or in part, and directly or indirectly) from that property, or
> (c) any other property, but only if it is dealt with as mentioned in section 809L(4)(a), (b) or (c) by virtue of an operation which is effected—
> (i) with reference to the gift of the property to the gift recipient, or
> (ii) with a view to enabling or facilitating the gift of the property to the gift recipient to be made.
> (8) [extends subsection (7) - as before].
> (9) Enjoyment by ~~a relevant person~~ <u>the individual</u> of property or a service is to be disregarded in any of these cases—

(a) if the property or service is enjoyed virtually to the entire exclusion of ~~all relevant persons~~ the individual,
(b) if full consideration in money or money's worth is given by ~~a relevant person~~ the individual for the enjoyment, or
(c) the property or service is enjoyed by ~~relevant persons~~ the individual in the same way, and on the same terms, as it may be enjoyed by the general public or by a section of the general public.

This does not restrict condition C: it *widens* it. The rule is not however very different from that which applied under the pre-2008 law.

10.22.8 Becoming or ceasing to be a relevant person: condition C

Section 809N ITA provides:

> (3) The question of whether or not a person is a relevant person is to be determined by reference to the time when a gift is made.
> (4) But, if a person to whom a gift is made subsequently becomes a relevant person, the person ceases to be a gift recipient.

Thus if a gift is made to a relevant person, condition C cannot apply even if they cease to be a relevant person.[66] If a gift is made to a non-relevant person, condition C ceases to apply if they become a relevant person

10.23 Remittance condition D

Section 809L(5) ITA provides:

> Condition D is that property of a person other than a relevant person (apart from qualifying property of a gift recipient)—
> (a) is brought to, or received or used in, the UK, and is enjoyed by a relevant person,
> (b) is consideration for a service that is enjoyed in the UK by a relevant person, or
> (c) is used outside the UK (directly or indirectly) in respect of a relevant debt,
> in circumstances where there is a connected operation.

66 See 10.20 (Becoming or ceasing to be a relevant person: condition A); 10.23.4 (Becoming or ceasing to be a relevant person: condition D)

We need some terminology to grapple with this, and in the following discussion:
“The non-relevant person” is “the person other than a relevant person.”
“**Condition D property**” is property of the person other than a relevant person (apart from qualifying property of a gift recipient).
The RDR Manual provides:

> The property that is brought to the UK, or used outside the UK as consideration for a service or in respect of a relevant debt must not be qualifying property of a gift recipient as this will fall within Condition C. However this restriction relates to the property not the individual, so the same person may be a gift recipient under Condition C and, in other transactions, “a person whose property is used” under Condition D.

The wording in (a) (b) (c) is the same as in remittance condition C and the same timing rule applies; for a discussion see 10.22 (Remittance condition C).
The key term here is connected operation. Section 809O provides the definition and other supplemental provisions for condition D. Section 809O(1) ITA provides:

> This section applies for the purposes of determining whether or not income or chargeable gains of an individual are remitted to the UK by virtue of condition D in section 809L(5).

10.23.1 *Connected operation*

Section 809O(3) ITA defines “connected operation”:

> A “connected operation”, in relation to property dealt with as mentioned in section 809L(5)(a), (b) or (c), means an operation which is effected—
> (a) with reference to a qualifying disposition, or
> (b) with a view to enabling or facilitating a qualifying disposition.

The RDR Manual provides:

> It is important to note the words “with reference to” and “with a view to enabling or facilitating a qualifying disposition”. The nature of the link between the connected operation and the qualifying disposition, or even

which comes first, is not specified. This means that a taxpayer cannot avoid a charge to tax by setting up complex structures to disguise foreign income or gains, or to try and "break the link" between something enjoyed in the UK and that income or those gains.

Section 809O ITA then defines "qualifying disposition":

(4) A "qualifying disposition" is a disposition that—
- (a) is made by a relevant person,
- (b) is made to, or for the benefit of, the person whose property is dealt with as mentioned in section 809L(5)(a), (b) or (c), and
- (c) is a disposition of money or other property that is, or derives (wholly or in part, and directly or indirectly) from, income or chargeable gains of the individual.

(5) But a disposition of property is not a qualifying disposition if the disposition is, or is part of, the giving of full consideration in money or money's worth for the dealing that falls within section 809L(5)(a), (b) or (c).

10.23.2 *Exceptions*

Section 809O(6) ITA provides the same three exceptions as for condition C:

Enjoyment by a relevant person of property or a service is to be disregarded in any of these cases—
- (a) if the property or service is enjoyed virtually to the entire exclusion of all relevant persons;
- (b) if full consideration in money or money's worth is given by a relevant person for the enjoyment; or
- (c) the property or service is enjoyed by relevant persons in the same way, and on the same terms, as it may be enjoyed by the general public or by a section of the general public.

For a discussion, see 10.22.4 (Exceptions).

10.23.3 *Transitional rules: pre-2008 income/gains*

Para 88 Sch 7 FA 2008 provides:

Section 809O of ITA 2007 (section 809L: dealings where there is a

connected operation) has effect in relation to an individual's income and chargeable gains for the tax year 2007-08 or any earlier tax year as if—
(a) subsection (2) were omitted, and
(b) the references in subsections (4) and (6) to a relevant person, all relevant persons, or relevant persons were to the individual.

Amended as para 88 requires, s.809O provides:

> (1) This section applies for the purposes of determining whether or not income or chargeable gains of an individual are remitted to the United Kingdom by virtue of condition D in section 809L.
> (3) A "connected operation", in relation to property dealt with as mentioned in section 809L(5)(a), (b) or (c), means an operation which is effected—
> (a) with reference to a qualifying disposition, or
> (b) with a view to enabling or facilitating a qualifying disposition.
> (4) A "qualifying disposition" is a disposition that—
> (a) is made by ~~a relevant person~~ *the individual*,
> (b) is made to, or for the benefit of, the person whose property is dealt with as mentioned in section 809L(5)(a), (b) or (c), and
> (c) is a disposition of money or other property that is, or derives (wholly or in part, and directly or indirectly) from, income or chargeable gains of the individual.
> (5) But a disposition of property is not a qualifying disposition if the disposition is, or is part of, the giving of full consideration in money or money's worth for the dealing that falls within section 809L(5)(a), (b) or (c).
> (6) Enjoyment by ~~a relevant person~~ *the individual* of property or a service is to be disregarded in any of these cases—
> (a) if the property or service is enjoyed virtually to the entire exclusion of ~~all relevant persons~~ *the individual,*
> (b) if full consideration in money or money's worth is given by ~~a relevant person~~ *the individual* for the enjoyment, or
> (c) the property or service is enjoyed by ~~relevant persons~~ *the individual* in the same way, and on the same terms, as it may be enjoyed by the general public or by a section of the general public.

10.23.4 *Becoming/ceasing to be a relevant person: condition D*

Section 809O(2) ITA provides:

> For the purposes of section 809L(5), the question of whether or not the person whose property is dealt with as mentioned in para (a), (b) or (c) of section 809L(5) is a relevant person is to be determined by reference to the time when the property is so dealt with.

10.23.5 *HMRC examples*

The RDR Manual provides a subtle example where the facts (stripping out irrelevancies)[67] are:

> T wishes to use land owned by X.
> T uses RFI to purchase a yacht outside the UK.
> T transfers the yacht to a company owned by X, at an undervalue.
> X, with reference to the transfer of the yacht, allows T to use the land in the UK rent free.

If the transfer of the yacht is consideration for the use of the land then there is a straightforward remittance under remittance conditions A and B. It is assumed (somewhat implausibly) that the transfer is not for consideration.

The HMRC analysis is as follows:

> X is not a gift recipient (the yacht was given to his company, not to X). Condition C cannot therefore apply.

However condition D will apply:

> [1] X is not a relevant person in relation to T.[68]
> [2] There is a qualifying disposition because:
> [a] There is a disposal of property (the yacht) which derived from T's income (ITA07/S809O(4)(c))

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67 The example (including its irrelevant detail) in full is as follows:

> John personally owns a country estate in Cornwall, in an area of outstanding natural beauty. His friend Janet wishes to use the mansion for several important family functions.
> Janet is a remittance basis user. She owns a foreign yacht which she bought using her foreign income and gains. On 2 March she disposes of the yacht to a nonresident company for less than a third of its cost and less than its current value.
> John has a controlling interest in that non-resident company. In October, with reference to the transfer of the yacht, John allows Janet full and exclusive use of the estate, rent-free.

68 The HMRC analysis adds that "the company is not a relevant person (as T is not a participator)" but it makes no difference whether or not the company is a relevant person.

> [b]The disposal was made by a relevant person (T) (ITA07/S809O(4)(a))
> [c] The disposal was for the benefit of X (although the disposal was not made directly to X, he benefits from it through his ownership of the company) (ITA07/S809O(4)(b))
> [3] X's property [the land] is enjoyed in the UK by a relevant person (T) (ITA07/S809L(5)(a) and ITA07/S809O(4)(b)).
> In this example T's advantage is due to a connected operation[69] (ITA07/S809O(3)) and Condition D will be met. Some or all of the foreign income used by T to acquire the yacht will be remitted.

Take the same facts but assume that X was a relevant person in relation to T. Condition D would not be satisfied and there would be no remittance.

Take the same facts in another order:

> (1) T uses land owned by X rent-free.
> (2) Subsequently, T transfers RFI to a company owned by X

Condition D is not satisfied at stage (1) as there is no connected operation. There is no charge at stage (2): one could not say that X's property is enjoyed "in circumstances where there *is* [present tense] a connected operation."

10.24 Amount remitted

Section 809P(1) ITA provides:

> The amount of income or chargeable gains remitted to the UK is to be determined as follows.

Five rules then follow.

10.24.1 *Remittance of the actual income or gains*

Section 809P(2) ITA provides:

69 This wording is a loose paraphrase of the statutory language, but it does not matter.

> If the property, service or consideration[70] is the income or chargeable gains, the amount remitted is equal to the amount of the income or chargeable gains.

That is sensible, indeed self-evident.

10.24.2 *Remittance of derived property*

Section 809P(3) ITA provides:

> If the property, service or consideration derives from the income or chargeable gains, the amount remitted is equal to the amount of income or chargeable gains from which the property, service or consideration derives.

The RDR Manual provides:

> Where, as in most cases, the property, service or consideration derives from a foreign currency, the taxable amount is the pounds sterling equivalent value of the foreign currency (see Chapter 1: Exchange rates) at the time it was used to acquire or pay for the property or service etc. This means that where an item of depreciating value (such as a car) is brought to the UK the amount that is liable to tax is not the current value of the car but the amount of foreign income or gains from which the car derives (example 4). For the same reason, where an item of appreciating value (perhaps a work of art) is brought to the UK, the taxable amount is the amount of foreign income or gains from which the property derived, and not its current market value (example 5).
> The same principle applies where an investment is made in shares or other such financial instruments, and those shares are in, or are otherwise brought, to the UK. The chargeable amount is the amount of foreign income or gains from which the shares derived.
> When taken together with any amounts that have been previously remitted (or treated as having been remitted), the taxable amount of income or gain that is treated as having been remitted because of these provisions cannot be greater than the amount of the original foreign

70 The words "property, service or consideration" relate back to the wording of condition B: property means property brought/received/used in the UK, service means a service provided in the UK, and consideration means consideration for a service provided in the UK.

> income and gains (ITA07/s809P(12)). Where property is brought to or used in the UK by or for the benefit of a relevant person the amount that is liable to tax is the amount of the underlying foreign income or gains from which the property derives (whether directly or indirectly). The taxable remittance will only occur once; this will usually be the time the asset is first brought to, received by or used in the UK by a relevant person.
>
> ...

The RDR Manual provides an example where the facts (stripping out irrelevancies)[71] are as follows:

> *Example 4*
> M, a remittance basis user, used £25,000 of her foreign chargeable gains to purchase a car. Marianne kept the car outside the UK.
> A few years later M brings the car to the UK. Its market resale value of the car is [implausibly] £14,000.

The HMRC analysis is as follows:

> The amount remitted is still £25,000, that being the amount equal to the chargeable gains from which the property – the car – derived.

The author has not addressed the interesting questions which arise if Marianne sells the car abroad and remits the proceeds of sale or buys a new car.

Suppose:

(1) T invests £3m foreign income in an asset,
(2) T sells the asset at a loss and receives only £1m.
(3) T remits the £1m.

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71 The example (including its irrelevant detail) in full is as follows:
In example 1 above, Marianne, a remittance basis user, used £25,000 of her foreign chargeable gains to purchase a car. The car is regarded as derived from foreign income and gains.
Instead of bringing it straight to the UK, Marianne kept the car at her Italian villa for use on her visits to Italy. A few years later she then decides to bring the car to the UK for her and her daughter to use. At this time the approximate market resale value of the car is £14,000.

Under the pre-2008 remittance basis the amount remitted was £1m only. Now the amount remitted is £3m. The tax exceeds the amount remitted. I doubt if anyone will observe this in practice. Perhaps a purposive approach allows one to read in a requirement that the amount remitted cannot exceed the amount of the money remitted.

Conversely suppose:

(1) T invests £3m foreign income in an asset,
(2) T sells the asset at a gain and receives £6m.[72]
(3) T remits £3m.

The amount remitted is only £1.5m, one half of the foreign income.

10.24.3 *Debt remittances*

Section 809P ITA provides:

> (4) If the income or chargeable gains are used as mentioned in section 809L(3)(c), [that is, used to satisfy a relevant debt] the amount remitted is equal to the amount of income or chargeable gains used; but this is subject to subsection (10).
> (5) If anything deriving from the income or chargeable gains is used as mentioned in section 809L(3)(c), [that is, used to satisfy a relevant debt] the amount remitted is equal to the amount of income or chargeable gains from which what is used derives; but this is subject to subsection (10).

This is the equivalent of s.809P(2)(3) for debt remittances, but here there is an apportionment rule to which I now turn.

10.24.4 *Apportionment rule for debt remittances*

Section 809P(10) ITA provides:

72 For simplicity assume the gain on this disposal is not within the charge to CGT (e.g. the gain is not a chargeable gain or T was non-resident when the gain accrued).

> If the debt is only partly in respect of[73] the property or service, the amount remitted is (if it would otherwise be greater) limited to the amount the debt would be if it were wholly in respect of the property or service.

Suppose:

(1) T borrows £10m.
(2) T remits £1m of the borrowed sum to the UK.

The *entire* debt is a relevant debt. Suppose then T repays the entire borrowing out of income/gains. Only £1m is treated as remitted.

Suppose T only repaid £1m or £2m of the debt. There is still a remittance of £1m. This example illustrates a planning point: one should avoid debts which relate *partly* to UK property. Instead of the above, T should borrow so as to have two separate debts, one of £1m (remitted to the UK) and one of £9m (unremitted). Then the unremitted debt is *not* a relevant debt and can be repaid out of foreign income/gains.

The apportionment rule applies where a relevant debt is partly in respect of the property received in the UK. What if property is used partly in respect of a relevant debt?

10.24.5 *Cap on amount remitted*

Section 809P(12) ITA provides:

> If the amount remitted (taken together with any amount previously remitted) would otherwise exceed the amount of the income or chargeable gains, the amount remitted is limited to the amount which, when taken together with any amount previously remitted, is equal to the amount of the income or chargeable gains.

How could the amount remitted exceed the amount of the income or the gains? One case is a deemed gain on a disposal for less than full consideration.

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73 Section 809P(10) refers to a debt *in respect of* UK property but the definition of relevant debt is one which *relates to* UK property. It is considered that the expressions are synonymous.

Another case is if income is remitted (the remittance conditions are met) and then the remittance conditions are met again, in relation to the same income or gains. There are many ways that this could happen, but one case concerns re-remittances. Suppose:

(1) Year 1: T (an individual taxable on the remittance basis) receives foreign income. The income is remitted ("the first remittance") and so subject to tax.
(2) Year 2: The income is transferred out of the UK and remitted again ("the re-remittance").

FAQ Remittances (April 2008) provides a straightforward example:

> If an asset is purchased by a non-domiciled individual out of untaxed foreign income abroad after 6 April 2008 and then remitted to the UK, and tax is paid on that remittance under the new legislation, but that asset is subsequently taken out of the UK by the same person and then remitted again, is there a second tax charge on the second remittance? Once a taxable remittance has arisen, the amount taxed in the UK will not be taxed again if the asset is subsequently removed from the UK and then brought back.

This is obviously right. But the same would apply if the income were not taxed on the first remittance, e.g. a remittance before 2008 of source-ceased income or of property enjoyed in specie. The same would apply to cash. HMRC agree. December 2008 Qs & As provides:

> **Q9** If a taxpayer undertook a source ceasing exercise during the 2006-07 tax year and then remitted the proceeds before the 2008-09 tax year, if those funds were to then be taken back outside of the UK and re-imported, would this constitute a remittance. In other words, would the earlier source ceasing exercise be looked through despite its timing? It is understood that interest/profit from any new investment would be a remittance.
> **A** If the source ceased in 2006-07 and was remitted in 2007-08, then this did not count as a remittance and it will not count as a remittance if it is exported and subsequently re-imported.

HMRC do not cite a statutory authority to justify their answer: s.809P(12)

ITA would do so, though there are others as well.[74]
March 2009 Qs & As provides:

> **Q8:** The term "used in" in section 809L(2)(a) is very wide and could mean that an asset is in a continuous state of remittance (ie if it is used in more that one year) or that an asset taxed when it is brought to, or received in, the UK would again be taxable when it is later used here. Could HMRC please comment?
> **A:** Subject to the various asset exemptions, an asset brought to the UK will trigger a taxable remittance only to the extent of the underlying income or gains from which it is derived (indirectly or directly). The taxable remittance will only occur once; this will usually be the time the asset is first brought to the UK by a relevant person, but otherwise will be the time that the asset is first received or used by a relevant person. See section 809P(3) ITA 2007.

10.24.6 *Condition C and D cases*

Section 809P ITA provides:

> (6) In a case falling within section 809L(4)(a) or (b), the amount remitted is equal to the amount of the relevant income or chargeable gains.
> (7) In a case falling within section 809L(4)(c), the amount remitted is equal to the amount of the relevant income or chargeable gains; but this is subject to subsection (10).
> (8) In a case falling within section 809L(5)(a) or (b), the amount remitted is equal to the amount of the income or chargeable gains referred to in section 809O(4)(c).
> (9) In a case falling within section 809L(5)(c), the amount remitted is equal to the amount of the income or chargeable gains referred to in section 809O(4)(c); but this is subject to subsection (10).
> ...
> (11) In subsections (6) and (7) "relevant income or chargeable gains" means—
> (a) if the qualifying property falls within section 809N(7)(a), the income or gains—
> (i) of which the qualifying property consists, or

74 Para 86(2) Sch 7 FA 2008 would also provide relief here: see 10.56 (Transitional rules for remittance in specie).

(ii) from which the qualifying property derives;

(b) if the qualifying property falls within section 809N(7)(b), the income or gains—

(i) of which the property given to the gift recipient consisted, or

(ii) from which that property derived;

(c) if the qualifying property falls within section 809N(7)(c), the income or gains—

(i) of which the property given to the gift recipient consists, or

(ii) from which that property derives.

The RDR Manual offers seven examples.

10.25 CGT disposal not for market value

10.25.1 *The CGT background*

In certain circumstances the consideration for a disposal is deemed to be market value consideration, not the actual consideration (if any).[75]

In certain circumstances a disposal is treated as being made when there is no actual disposal.

In these cases a gain is deemed to accrue which is not a real gain (in the sense that the individual does not receive a sum which is or is derived from the gain.) This is referred to as **"a deemed gain"**.

The most common case of a deemed gain is a gift: in economic reality a gift cannot give rise to a gain and normally gives rise to a loss. However, for CGT purposes a gift is treated as made for market value.

10.25.2 *Deemed gains and the remittance basis from 22 April 2009*

In the absence of express provision the deemed gain arising on the gift could not be remitted, because it does not exist (in the sense that the individual does not receive a sum from the disposal which is or is derived

75 Section 17(1) TCGA sets out seven sets of circumstances when a disposal is treated as made for market value. (The section also deems certain acquisitions to be for market value, but we are not concerned with that here.)
In certain circumstances a gain is deemed to accrue to an individual even though there is no disposal, but s.809T does not apply to that.

from the gain). Accordingly, s.809T ITA provides:

> **809T Foreign chargeable gains accruing on disposal made otherwise than for full consideration**
> (1) This section applies if—
> (a) foreign chargeable gains accrue to an individual on the disposal of an asset, and
> (b) the individual does not receive consideration[76] for the disposal of an amount at least equal to the market value[77] of the asset.
> (2) For the purposes of this Chapter, treat the asset as deriving from the chargeable gains.

It is not expressly stated that this only applies on a disposal made by an individual, but this is implied. Eg on a disposal by non-resident close company, gains may accrue to the individual who is a participator, and the individual does not receive the consideration for the disposal, but s.809T does not apply. Otherwise provisions such as s.14A(3)(a) TCGA would be unnecessary.

10.25.3 *Gift of asset*

Suppose:

(1) T (a remittance basis taxpayer) gives an asset (foreign situate) to a trust. A gain is deemed to accrue on the disposal as if the asset were sold for market value. (Assume the asset has risen in value and a gain accrues.)
(2) T (or a relevant person) receives the asset in the UK.

The deemed gain is remitted. This reverses the rule for the pre-2008 CGT remittance basis.

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76 "Consideration" here obviously means actual consideration, as opposed to market value which is (usually) deemed to be given by s.17(1) TCGA. (Though normally in the legislation the drafter states this expressly; e.g. s.165(7) TCGA.)

77 Para 171 Sch 7 FA 2008 defines "market value" for the purposes of Part 2 of Schedule 7 ("For the purposes of this Part of this Schedule, the market value of any asset is its market value for the purposes of TCGA 1992"). Accordingly market value here is not defined. But in practice no difficulty will arise.

10.25.4 *Sale of asset*

Suppose T sells an asset to a trust for £100. (Assume T is connected with the trustees.)

If the market value is equal to the purchase price (£100) then s.809T does not apply. It does not matter that the sale is to a connected person. The purchase price is or (better) is derived from the gain but the asset itself is not (and is not derived from) the gain. So it does not matter if the asset is remitted.

Suppose T sells an asset and the purchase price is left outstanding as a loan. It is considered that T "receives" the consideration, for the benefit of the loan is the consideration.

Suppose a sale at an undervalue (the market value is more than the purchase price). In this case

(1) the asset is deemed to be derived from the gain; *and*
(2) the purchase price is or is derived from the gain.

This rule applies to all sales at less than market value, even if accidental.

This rule applies if the sale is less than market value even if it is 99% of the market value.

It is not necessary to have a disposal between connected persons, though in practice the section is not likely to apply to a disposal between unconnected persons.

Suppose:

(1) the asset is worth £200 and has a base cost of £50.
(2) the asset is sold for £100 giving rise to a deemed gain of £150.

If the £100 sale proceeds is received in the UK it is suggested that half – £75 – of the gain should be regarded as remitted. If the asset is also received in the UK by a connected person, then there is a remittance of the entire gain. However the cap on the amount remitted avoids double taxation.[78]

If the asset is sold for base cost, £50, it is suggested that the £50 is not derived from the deemed gain, so the £50 sale proceeds could be remitted

78 See 10.24.5 (Cap on amount remitted).

tax free. But other views are possible.

10.25.5 *Transitional rules: pre-2008 gains*

Subject to immaterial exceptions, para 81 Sch 7 FA 2008 provides:

> The amendments made by this Part of this Schedule have effect for the tax year 2008-09 and subsequent tax years.

A deemed gain accrued to an individual on gifts made before 2008/9: it was just not remittable. At first sight this does not help. It is accepted that the ITA remittance basis rules govern pre-2008 income/gains. So after 2008/9 s.809T applies and the gain becomes remittable, though it qualifies for RP relief. It does not matter when (after 1965) the gain arose: gains from disposals made in the 1960s could now come into charge, though all records will have been long discarded. But HMRC do not take that view. FAQ: Residence and Domicile – NR Trusts provides:

> **Will a deemed chargeable gain that arose when I gifted foreign assets to the trustees of a non UK resident settlement before 6 April 2008 become taxable if the trustees remit the property to the UK on or after 6 April 2008?**
> No, a deemed chargeable gain accruing on the gift of property to a non resident trust before 6 April 2008 will not become chargeable if the trustees remit the property or anything derived from it to the UK on or after 6 April 2008.
> However where there was no real alienation of the income or gains by the individual, as for example in the case of *Harmel v Wright*, because the settlor retained effective control over them, then the position after 5 April has not changed. In such a case the income or gains could be taxed on the settlor.[79]

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79 The point is confirmed in the Public Bill Committee Debate 19 June 2008. Hansard col 834 and 840:

> "**Mr. Hoban:** the new section 809R set out in schedule 7 creates some uncertainty in the minds of advisers as to meaning. The optimistic, preferred best interpretation is that new section 809R does not apply in relation to gains that arose prior to 6 April 2008, It is understood that that is also the view of HMRC. Accordingly, the old legislation states that, provided that there was a genuine gift, there would be no tax liability on the gain that arose when the gift was made. while it has been helpful for HMRC to have made its view

It seems to me that *Harmel v Wright* 49 TC 149 has nothing to do with the case; though of course a trust could be disregarded under the sham doctrine.

10.25.6 *Transitional rules: 6 April 2008 and 21 April 2009*

Between 6 April 2008 and 22 April 2009, s.809T provided:

> **809T Foreign chargeable gains accruing on disposal made other~~wise~~ than for full consideration**
> (1) This section applies if—
> (a) foreign chargeable gains accrue to an individual on the disposal of an asset, and
> (b) the individual does not receive consideration[80] for the disposal of an amount ~~at least~~ equal to the market value[81] of the asset.
> (2) For the purposes of this Chapter, treat the asset as deriving from the chargeable gains.

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known, doubt and concern still remain.

The potential sums will often be significant, and it is likely that inadequate records will have been kept to establish the position since, at the time, the law was clear that there could never be a tax charge as a result of the gift,. Accordingly, taxpayers who made gifts of foreign assets offshore prior to 6 April 2008 will be concerned by the split in opinion; some suggest that new section 809R could exist retrospectively. Taxpayers who made absolute unfettered gifts of foreign assets offshore prior to 6 April 2008 had a legitimate expectation that the gain deemed to have been realised on the making of the gift would never come into charge. The new legislation should be clear, which is why amendment No. 375 seeks to insert:

> 'This section shall not have effect with respect to gains accruing to an individual on the disposal of an asset if the disposal took place prior to 6 April 2008.'

Jane Kennedy (Financial Secretary to the Treasury): On the very specific point about unfettered gifts of foreign assets offshore, HMRC made its view very clear in a frequently asked question some time ago. In simple terms, it is only when such gifts were made after 6 April 2008 that they would be taxed."

80 "Consideration" here obviously means actual consideration, as opposed to market value which is (usually) deemed to be given by s.17(1) TCGA. (Though normally in the legislation the drafter states this expressly; e.g. s.165(7) TCGA.)

81 Para 171 Sch 7 FA 2008 defines "market value" for the purposes of Part 2 of Schedule 7 ("For the purposes of this Part of this Schedule, the market value of any asset is its market value for the purposes of TCGA 1992"). Accordingly market value here is not defined. But in practice no difficulty will arise.

What if T sold and received *more* than the market value? Taken literally, s.809T applied. But that is absurd and it is suggested that a purpose construction should be applied. If that is right the 2009 amendment to s.809T(1) did not change the law. In practice the question will not often arise.

EN FB 2009 states:

> 16. Paragraph 9 corrects a grammatical error in section 809T of ITA.

In fact para 9 makes two corrections, a stylistic correction to the section heading (which would only have troubled the most delicate of readers) and an amendment to the text of s.809T(1) which is important. It is casual if not contemptuous that the author of the EN should mention the former and ignore the latter. But there it is.

10.26 Purchase of family home

Suppose

(1) T gives RFI to his son S, not a relevant person.
(2) S buys the freehold interest of a house and uses the RFI to pay the purchase price.

The topic raises many remittance issues, discussed throughout this chapter, so it is convenient to draw them together.

10.26.1 *Rent-free occupation*

Suppose S allows T to occupy the house rent-free. It is considered that S "uses" the house (the word "use" is wide enough to cover this even though it would be more normal and better legal English to say S occupies or enjoys the use of the house.) Accordingly remittance condition A is satisfied. The house is derived from the RFI, but condition B is not satisfied because the property is not property of a relevant person.

Remittance condition C is satisfied, since the property is qualifying property of a gift recipient, and is used and enjoyed by a relevant person. So the purchase price RFI is remitted.

10.26.2 *Lease granted for full consideration*

Now suppose:

(1) T gives RFI to his son S, who uses it to buy the freehold interest of a house.
(2) S grants a lease of the property to T for full consideration and T occupies the property. S retains the freehold reversion.

One must ask various questions here.

Firstly, does T use the lease? The answer is that T does "use" the lease (see above.) So remittance condition A is satisfied in relation to the lease. However the lease is not derived from the RFI. So condition B is not satisfied. Of course funds T uses to pay for the lease are regarded as remitted.

Next, does T use the reversion? If so condition A is satisfied in relation to the reversion. However that may be, the reversion is not property of a relevant person so condition B is not satisfied.

Conditions C and D are excluded (even if they could otherwise apply) since the full consideration exemption applies.

10.26.3 *Lease granted for less than full consideration*

Now suppose:

(1) T gives RFI to his son S, not a relevant person, who uses it to buy the freehold interest of a house.
(2) S grants a lease of the property to T for no consideration or for less than full consideration, and T occupies the property. S retains the freehold reversion.

One must ask various questions here.

Firstly, does T use the lease? The answer is that T does "use" the lease (see above.) So remittance condition A is satisfied in relation to the lease. If the transactions are part of an arrangement, the lease is derived from the RFI. So condition B is satisfied (as the lease is property of a relevant person). What is the amount remitted? It is the amount from which the lease is derived. It is suggested that that is not the full amount used to pay for the property, but only a part reflecting the value of the lease.

Next, does T use the reversion? If so condition A is satisfied in relation to the reversion. However that may be, the reversion is not the property of a relevant person so condition B is not satisfied.

Turning to remittance condition C, does T enjoy the lease for the purposes of remittance condition C? He does. At first sight this does not matter as the lease is not qualifying property of a gift recipient (it is not property of a gift recipient). The lease may (depending on the facts) however be qualifying property within s.809N(7)(c). If so the amount remitted is all the RFI (not the value of the lease).

Next, does T use and enjoy the reversion? It is considered that he does, since the lease he enjoys is derived from the reversion, and the lease is the mechanism by which he enjoys the reversion. If that is right, then condition C is satisfied, since the reversion is qualifying property of a gift recipient.

10.26.4 *Another analysis*

Another analysis is that the "property" is the physical house, not the legal interests in the property, but one should not disregard the most basic principles of the law of real property in construing a taxing statute, if any other approach is possible.

10.27 Payment of school fees

Suppose T wishes to pay the school fees of his minor grandchildren. Assume the grandchildren are at school in the UK (otherwise there is no problem.) A direct payment out of RFI is a remittance as conditions A and B are satisfied.

Suppose T gives funds to his child (not a relevant person) and the child uses the funds to pay the fees. This is still a remittance as conditions A and B are still satisfied: the funds in the hands of the child are derived from the RFI.

Suppose there is an informal arrangement under which:

(1) T gives funds to his child;
(2) the child will use *other* funds to pay the school fees.

This is caught by condition C because the funds used to pay the fees are "qualifying property" within s.809N(7)(c). That is, it is used to pay the school fees by virtue of an operation which is effected "with reference to the gift of the property to the gift recipient".

T must therefore make an unconditional gift to his child ie a gift such that the payment of the school fees is not with reference to that gift; in that case (assuming the fees are not paid out of the gifted property) there is no remittance.

10.28 Mixed funds

I coin the following terminology:

"The ITA mixed fund regime" means the set of rules set out in s.809Q to 809S ITA.
"The pre-2008 mixed fund regime" means the case law rules applicable before 2008/09.

10.28.1 *Definition of "mixed fund"*

Section 809Q(6) ITA provides:

> In this section "mixed fund" means money or other property which, immediately before the transfer, contains or derives from—
> (a) more than one of the kinds of income and capital mentioned in subsection (4), or
> (b) income or capital for more than one tax year.

This is only a section-wide definition so the drafter has to repeat it verbatim in the next section where the expression "mixed fund" is used again.

One must first identify what is the fund, and then identify the constituents which it contains (or derives from).

10.28.2 *Identifying the fund*

Funds are distinct, i.e., not mixed, if they are held in separate accounts or sub-accounts at one bank even though a bank in principle owes only a single debt to its customer. HMRC agree. The RDR Manual provides:

> *No Mixed Fund*
> Also, a mixed fund does not exist just because the individual has several accounts with the same banking institution, if each account is separately constituted and contains only one of the relevant types of income *from only one year*. This will usually include bank accounts set up as sub-accounts under an "umbrella" agreement.
> If income and capital sources from a tax year are maintained separately (sometimes referred to as "kept clean" or "clean capital") no mixed fund is created, and so these rules will not apply.
> For example, an individual maintains three separate accounts with the same offshore institution:
> Account A into which he pays his relevant foreign earnings for the tax year
> Account B into which he pays some inherited money (clean capital).
> Account C into which he pays some relevant foreign income for the tax year
> As long as these accounts do not become mixed funds, the individual can bring money into the UK from Account B and that will be accepted as a being a transfer of "clean" capital, and so will not be a taxable remittance.

Accordingly one can in principle avoid mixing income with other funds by arranging that the income is paid to a separate bank account. If one does that it will be possible to remit capital and to keep income unremitted.

The RDR Manual provides:

> *Interest credits to a capital account*
> Often interest on a maturing deposit is credited to the same account comprising the principal capital investment, but under the bank's normal internal system the interest is then immediately and identifiably transferred to an income account.
> Where a mixed fund such as this is created fleetingly by an operation of the banking system, HMRC will accept that the interest credit will not taint the principal and so that the mixed fund rules in ITA07/s809Q to S do not apply.

I think this practice is strictly concessionary.

The position is different for capital gains. A capital gain has no separate identifiable existence.[82]

10.28.3 *Ingredients of a mixed fund*

We turn to s.809Q(4) ITA to see what kinds of income and capital may make up a mixed fund:

> The kinds of income and capital are—
> (a) employment income (other than income within para (b), (c) or (f)),
> (b) relevant foreign earnings (other than income within para (f)),
> (c) foreign specific employment income (other than income within para (f)),
> (d) relevant foreign income (other than income within para (g)),
> (e) foreign chargeable gains (other than chargeable gains within para (h)),[83]
> (f) employment income subject to a foreign tax,
> (g) relevant foreign income subject to a foreign tax,
> (h) foreign chargeable gains subject to a foreign tax, and
> (i) income or capital not within another paragraph of this subsection.

I refer to these nine categories as "**the mixed fund categories**". The order in which these categories is placed is important: I call this "**the mixed fund priority order**".

An individual needs to classify every mixed fund into these nine categories from 2008/09. This requires vastly more record keeping than the pre-2008 mixed fund regime.

Income which accrues to an individual when he is non-resident is not RFI[84] (even interest, dividends, etc which would be RFI if received by a UK resident). Similarly, earnings received by a non-resident is not employment income.[85] Such income falls into the bottom category (i). But all income of the year of arrival and departure constitutes RFI or

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82 See 10.13.2 (What is the gain?)

83 This applies even in the case of an individual who is resident, not ordinarily resident and UK domiciled, who qualifies for the remittance basis for income but not for gains.

84 Because it does not meet the condition in s.830(1)(b) ITTOIA; see 8.3.1 (Relevant foreign income).

85 Unless within s.27 ITEPA (duties performed in UK or overseas Crown employment).

employment income, even if ESC A11 applies.

Chargeable gains from non-UK assets which accrue to an individual when he is non-resident *are* foreign chargeable gains.[86] Such gains will fall within category (e) or (h) depending on whether they are subject to a foreign tax.

What if an individual receives foreign income or gains which are taxable, either because they are remitted to the UK or because no remittance basis claim is made in that year? The sums do not cease to be foreign income or gains, so they remain in their relevant categories (a) to (h).

"Foreign tax"

Section 809Q(5) ITA defines "foreign tax":

> In subsection (4) "foreign tax" means any tax chargeable under the law of a territory outside the UK.

At first I thought that tax deducted under the EU Saving Directive is not "foreign tax". The EU is not a territory outside the UK. But if tax is deducted in, say, Luxembourg, perhaps the better view is that the tax is chargeable under the law of *Luxembourg* so the tax is a foreign tax. The position may depend on whether or not the EU directive has direct effect in the MS concerned.

"Subject to a foreign tax"

The RDR Manual provides:

> Occasionally UK resident remittance basis users' UK employment income may be "subject to foreign tax", that is to say another country (usually their country of nationality or citizenship) will also tax them on this income. In these cases HMRC will accept that the individual's UK source employment income may still be regarded as within para (a) in the mixed fund, unless the individual requests otherwise, in which case it will remain to fall within para (f) as employment income subject to a foreign tax.
>
> This is only relevant where the other country has in fact subjected the

86 See 36.1 ("Chargeable gains") and 9.3.4 (Foreign chargeable gains).

> UK employment income under consideration to their tax. In many cases no tax will, in fact, have been due in or paid to the other country due to various exemptions and provisions, (for example the US has a "foreign earned income exclusion" provision to employment income below a certain level), so the UK employment income will be within para (a) anyway.

This is not consistent with the approach applied elsewhere in deciding what is "subject to tax": see 41.18 (Subject to tax).

Section 809Q(8) ITA provides:

> References in this section and section 809R to anything deriving from income or capital within para (i) of subsection (4) do not include—
>
> (a) income or gains within any of paras (a) to (h) of that subsection, or
>
> (b) anything deriving from such income or gains.

10.28.4 *Scope of onshore transfer mixed fund rule*

Section 809Q ITA provides:

> (1) This section applies for the purposes mentioned in subsection (2) ...
>
> (2) The purposes referred to in subsection (1) are—
>
> (a) determining whether condition B in section 809L is met, and
>
> (b) if it is met, determining (under section 809P) the amount of income or chargeable gains remitted.

Accordingly, the onshore transfer mixed fund rule does not apply for the purposes of remittance basis conditions C or D. This was presumably because those conditions do not always require the use of foreign income/gains or property derived from it. However conditions C and D will not often apply. So in practice the mixed fund rule applies for most remittance purposes. When conditions C and D are in point, one applies the pre-2008 mixed fund regime.

10.28.5 *Onshore transfer*

Section 809Q(1) ITA provides:

> This section applies ... where condition A in section 809L is met[87] and—
> (a) the property or consideration for the service is (wholly or in part), or derives (wholly or in part, and directly or indirectly) from, a transfer from a mixed fund, ...

The drafter has (again) confused a transfer and the property transferred by a transfer, but the meaning is clear enough. Expanding this, it should be read to mean:

> This section applies ... where condition A in section 809L is met and—
> (a) [i] the property or consideration for the service is (wholly or in part) ... [property transferred by] a transfer from a mixed fund, or
> [ii] the property or consideration for the service ... derives (wholly or in part, and directly or indirectly) from [property transferred by] a transfer from a mixed fund...

I refer to a transfer to which s.809Q applies as an **"onshore transfer"**.

The next part of s.809Q(1) deals with debt remittances:

> This section applies ... where condition A in section 809L is met and—
> (b) a transfer from a mixed fund, or anything deriving (wholly or in part, and directly or indirectly) from such a transfer, is used as mentioned in section 809L(3)(c).

In short, there is an onshore transfer in six cases:

(1) A relevant person receives UK property which:
 (a) is from a mixed fund or
 (b) is derived from a mixed fund
(2) A relevant person receives a UK service, consideration for which:
 (a) is from a mixed fund or
 (b) is derived from a mixed fund
(3) A relevant debt:
 (a) is satisfied out of a mixed fund or
 (b) is satisfied out of a fund derived from a mixed fund.

87 See 10.11 (Remittance condition A).

10.28.6 *Transfer*

Transfer is not defined but the context shows that it means any payment out of the mixed fund, whether or not for consideration.

Section 809Q(7) ITA defines the amount of a transfer:

> References in this section to the amount of the transfer include the market value of it.

Strictly one must value the asset transferred, not the transfer, but the meaning is clear.

10.29 Onshore transfer mixed fund rule

We can turn at last to the rule itself. Section 809Q(3) ITA provides:

> The extent to which the transfer is of the individual's income or chargeable gains is to be determined as follows.

Section 809Q(3) ITA then sets out five steps. It is easier to follow the steps if one has an example in mind. Suppose T (a remittance basis taxpayer) receives £100 per annum of each of the mixed fund categories and pays them into one mixed fund:

Category	**Type of income (in short)**	**Year 1**	**Year 2**
(a)	employment income	£100	£100
(b)	relevant foreign earnings	£100	£100
(c)	foreign specific employment income	£100	£100
(d)	relevant foreign income	£100	£100
(e)	foreign chargeable gains	£100	£100
(f)	foreign taxed employment income	£100	£100
(g)	foreign taxed RFE	£100	£100
(h)	foreign taxed gains	£100	£100
(i)	other income and capital	£100	£100

There is therefore a mixed fund of £1800. Suppose T remits nothing in year 1 and £1,000 to the UK in year 2. This is an onshore transfer. One follows the steps thus:

> *Step 1*
> *For each of the categories of income and capital in paras (a) to (i) of subsection (4), find (applying section 809R) the amount of income or capital of the individual for the relevant tax year in the mixed fund immediately before the transfer.*
> *"The relevant tax year" is the tax year in which the transfer occurs.*

In the example, the relevant tax year is year 2. I consider this further below but for present purposes assume that "the amount of income or capital of the individual in the mixed fund immediately before the transfer" is as set out in the table above.

> *Step 2*
> *Find the earliest paragraph for which the amount determined under step 1 is not nil.*

The earliest paragraph is para (a) and the amount determined under step 1 is £100.

> *If that amount does not exceed the amount of the transfer, treat the transfer as containing the income or capital within that paragraph (and for that tax year).*

T's transfer is treated as containing £100 employment income category (a) for year 2.

> *Otherwise, treat the transfer as containing the relevant proportion of each kind of income or capital within that paragraph (and for that tax year).*
> *"The relevant proportion" is the amount of the transfer divided by the amount determined under step 1 for that paragraph.*

(Had the transfer been (say) £50 then the relevant proportion would have been £50÷£100 = 50% so the transfer would have been treated as containing £50 employment income category (a) for year 2.)

> *Step 3*
> *Treat the amount of the transfer as reduced by the amount taken into account under step 2.*

The amount of the transfer is reduced to £900.

> *Step 4*
> *If the amount of the transfer (as reduced under step 3) is not nil, start again at step 2.*
> *In step 2, read the reference to the earliest paragraph of the kind mentioned there as a reference to the earliest such paragraph which has not previously been taken into account under that step in relation to the transfer.*

Following this iterative process a total of nine times, the transfer is treated as containing:

(a) employment income	£100
(b) relevant foreign earnings	£100
(c) foreign specific employment income	£100
(d) relevant foreign income	£100
(e) foreign chargeable gains	£100
(f) foreign taxed employment income	£100
(g) foreign taxed RFI	£100
(h) foreign taxed gains	£100
(i) other income and capital	£100
Total	**£900**

The amount of the original £1,000 transfer is by this stage treated as reduced to £100. We move to the next step:

> *Step 5*
> *If the amount of the transfer (as reduced under step 3) is not nil once steps 2 and 3 have been undertaken in relation to all paragraphs of subsection (4) for which the amount determined under step 1 is not nil, start again at step 1.*
> *In step 1, read the reference to the relevant tax year as a reference to the tax year immediately before the last tax year for which step 1 has been undertaken in relation to the transfer.*

Thus we repeat step 2 a last and tenth time, reading “the relevant tax year” to mean year 1. So the transfer of £1,000 from the mixed fund is treated as being:

Category	Type of income (in short)	Income of year	Amount
(a)	employment income	2	£100
(b)	relevant foreign earnings	2	£100
(c)	foreign specific employment income	2	£100
(d)	relevant foreign income	2	£100
(e)	foreign chargeable gains	2	£100
(f)	foreign taxed employment income	2	£100
(g)	foreign taxed RFE	2	£100
(h)	foreign taxed gains	2	£100
(i)	other income and capital	2	£100
(a)	employment income	1	£100
Total			**£1,000**

In order to reach this answer for one single transfer we have had to carry out 37 steps.[88] Yet it will be common for there to be hundreds of transfers from any mixed fund.

10.29.1 *Commentary: drafting style*

In short, the effect of the onshore transfer mixed fund rule is that transfers from a mixed fund are treated as being made in the mixed fund priority order, taking more recent years before earlier years. Why didn’t the statute simply say so? What is the reason for the extraordinarily convoluted drafting style. I have wondered whether the legislation was drafted by someone who trained to write computer programs rather than legislation.

88 Steps 1–4 were each carried out 9 times and step 5 once.

I think the explanation may be that the use of "steps" was an innovation of the tax law rewrite in the search for new and clearer methods of drafting. If so, however, it must be judged a failure. But the fundamental problem is not the drafting, but conception of the mixed fund rule.

10.29.2 HMRC Examples

The RDR Manual provides examples. Omitting some irrelevant detail, they are as follows:

Remittances from mixed funds -identifying nature of remittance: Example 1

A, a remittance basis user, has

- foreign earnings from two employers totalling £40,000 per month, half of which is subject to foreign tax,
- relevant foreign income of £10,000 per quarter, which is not subject to foreign tax.
- some of her UK employment income (£50,000 per month) which has already been subject to tax in the UK is paid into the same offshore bank account.

On 15 October 2010 A purchases an aircraft for £460,000, which she brings to the UK.

2009-10		Credit	Debit	Balance	Category S809Q(4)
30 April	UK salary	£50,000		£50,000	**Para (a)**
30 April	Overseas salary (not subject to foreign tax)	£20,000		£70,000	**Para (b)**
30 April	Overseas salary (subject to foreign tax)	£20,000		£90,000	**Para (f)**
31 May	UK salary	£50,000		£140,000	**Para (a)**
31 May	Overseas salary (not subject to foreign tax)	£20,000		£160,000	**Para (b)**
31 May	Overseas salary (subject to foreign tax)	£20,000		£180,000	**Para (f)**
2 June	RFI	£10,000		£190,000	**Para (d)**
30 June	UK salary	£50,000		£240,000	**Para (a)**
30 June	Overseas salary (not subject to foreign tax)	£20,000		£260,000	**Para (b)**

30 June	Overseas salary (subject to foreign tax)	£20,000		£280,000	**Para (f)**
31 July	UK salary	£50,000		£330,000	**Para (a)**
31 July	Overseas salary (not subject to foreign tax)	£20,000		£350,000	**Para (b)**
31 July	Overseas salary (subject to foreign tax)	£20,000		£370,000	**Para (f)**
31 Aug	UK salary	£50,000		£420,000	**Para (a)**
31 Aug	Overseas salary (not subject to foreign tax)	£20,000		£440,000	**Para (b)**
31 Aug	Overseas salary (subject to foreign tax)	£20,000		£460,000	**Para (f)**
2 Sept	RFI	£10,000		£470,000	**Para (d)**
30 Sept	UK salary	£50,000		£520,000	**Para (a)**
30 Sept	Overseas salary (subject to foreign tax)	£20,000		£540,000	**Para (f)**
30 Sept	Overseas salary (not subject to foreign tax)	£20,000		£560,000	**Para (b)**
15 Oct	Aircraft purchase		£460,000	£100,000	

Step 1 – Identify the "amount of transfer" in the relevant year (2010-11)		£460,000
Analyse mixed fund to identify the separate amounts of income, capital gains and capital present for each tax year immediately before the date of the transfer	**Para (a)** UK employment income	£300,000
	Para (b) Relevant foreign earnings (not subject to a foreign tax)	£120,000
	Para (d) RFI (not subject to a foreign tax)	£20,000
	Para (f) Employment income subject to a foreign tax	£120,000

Step 2 – Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund	**Para (a)**	£300,000
Step 3 Where the amount transferred is greater than the amount identified at Step 2 the amount transferred is treated as reduced by the amount identified in Step 2.		£460k *less* £300k = £160,000
Step 4 - Find the next paragraph/amount for that tax year. In the order of preference listed above repeat Steps 2 and 3.		
Step 2 - repeated	**Para (b)**	£120,000
Step 3 - repeated	Amount transferred further reduced to:	£40,000
Step 4 In the order of preference listed above repeat Steps 2 and 3.		
Step 2 - repeated	**Para (d)**	£20,000
Step 3 - repeated	Amount transferred further reduced to:	£20,000
Step 4 In the order of preference listed above repeat Steps 2 & 3.		
Step 2	**Para (f)**	£120,000
Step 3 If the amount at Step 2 is equal to or more than the remaining amount of the transfer (the last time step 3 was completed) treat the whole of the remaining amount of the transfer as coming from that item of income or gain		£nil

There has been a transfer to the UK of £460,000. Of this, £300,000 is from UK employment income which has already been taxed, so will not be taxed again. There have also been taxable remittances of A's relevant foreign earnings (£140,000 (£20,000 of which was subject to a foreign tax) and relevant foreign income (£20,000)).
£100,000 of taxed foreign employment income (para f) remains in the offshore account fund.
...

Remittances from mixed funds–identifying nature of remittance–Example 3

J has
- UK salary of £10,000 a month paid into an overseas bank account.
- a salary for overseas employment and his net salary for that work of £5,000 a month is paid into the same bank account. Both salaries are paid on the last day of each month.
- Dividends from a shareholding in a foreign company are also paid into the account.

In Year 0, J had purchased shares in a foreign company for £8m. The £8m is accepted as representing J's "clean" capital, an inheritance. J sells the shares in

Year 2 for £10m, which produces a £2m chargeable gain.
J's remittances to the UK from this fund in that year are £10m.
His UK salary is credited net of PAYE and NIC. His overseas salary is subject to a foreign tax deducted at source, and is credited net. His overseas dividends are credited gross

		Credit	Debit	Balance	Category S809Q(4)
Year 1				£nil	
31 March	UK salary (net of tax)	£10,000		£10,000	**Para (a)**
31 March	Overseas salary (net of tax)	£5,000		£15,000	**Para (f)**
Year 2					
30 Apr	UK salary	£10,000		£25,000	**Para (a)**
30 Apr	Overseas salary	£5,000		£30,000	**Para (f)**
15 May	Dividend	£2,000		£32,000	**Para (g)**
15 May	UK salary	£10,000		£42,000	**Para (a)**
31 May	Overseas salary	£5,000		£47,000	**Para (f)**
18 June	Sale of shares (£8m capital and £2m gain (no deduction of foreign tax)	£2,000,000			**Para (e)**
		£8,000,000		£10,047,000	**Para (i)**
30 Jun	UK salary	£10,000		£10,057,000	**Para (a)**
30 Jun	Overseas salary	£5,000		£10,062,000	**Para (f)**
25 Jul	Dividend	£2,000		£10,064,000	**Para (g)**
31 Jul	UK salary	£10,000		£10,074,000	**Para (a)**
31 Jul	Overseas salary	£5,000		£10,079,000	**Para (f)**
31 Jul	Bank interest	£5,000		£10,084,000	**Para (d)**
14 Aug	Transfer to UK account		£10,000,000	£84,000	
31 Aug	UK salary	£10,000		£94,000	**Para (a)**

31 Aug	Overseas salary	£5,000		£99,000	**Para (f)**

Applying the ordering rules in S809Q to the account **immediately before the transfer:**

Step 1 – Identify the "amount of transfer" in the relevant tax year (Year 2)		£10,000,000
Analyse mixed fund to identify the separate amounts of income, capital gains and capital present for each tax year immediately before the date of the transfer	**Para (a)** Employment income (including UK employment income) not subject to a foreign tax	Year 1 – £10,000 Year 2 – £40,000
	Para (d) Relevant foreign income (not subject to a foreign tax)	Bank interest Year 2 - £5,000
	Para (e) Foreign chargeable gains (not subject to a foreign tax)	Year 2 - £2,000,000
	Para (f) Employment income subject to a foreign tax	Year 1 - £5,000 Year 2 - £20,000
	Para (g) Relevant foreign income subject to a foreign tax	Foreign dividends Year 2 - £4,000
Step 2 – Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund	**Para (a)**	£40,000
Step 3 Where the amount of the remittance is greater than the amount identified at Step 2 the amount remitted is treated as reduced by the amount identified in Step 2.		£10m less £40k = £9,960,000
Step 4 - Find the next paragraph/amount for that tax year. In the order of preference listed above repeat Steps 2 and 3.		
Step 2	**Para (d)**	£5,000
Step 3		£9,955,000
Step 4 - In the order of preference listed above repeat Steps 2 and 3		

Step 2	**Para (e)**	£2m
Step 3		£7,955,000
Step 4 - In the order of preference listed above repeat Steps 2 and 3		
Step 2	**Para (f)**	£20,000
Step 3		£7,935,000
Step 4 - In the order of preference listed above repeat Steps 2 & 3		
Step 2	**Para (g)**	£4,000
Step 3		£7,931,000
Step 4 - In the order of preference listed above repeat Steps 2 and 3		
Step 2 - If the amount is more than the [residual] "relevant amount", treat the whole of the remittance as coming from that item of income or gain.	**Para (i)**	£8m

The result of this exercise is that

- All of J's UK salary in tax year 2 is deemed to have been brought to the UK first.
- Similarly all of his foreign income and gains of tax year 2 are treated as remitted to the UK and chargeable to tax at the appropriate rates of tax – allowing credit for foreign taxes charged on that same income as appropriate.

- £7,931,000 capital has also been brought to the UK.

Until such time as further amounts of income and gains are credited to the overseas account, the mixed fund contains £69,000 of capital (from the sale of shares) together with £15,000 income of the previous tax year (Year 1).

Remittances from mixed funds – identifying nature of remittance – Example 3a (continuation)

Immediately after the £10m transfer in Year 2 (see example 3) J's mixed fund contains £69,000 of capital (from the sale of shares) and £5,000 overseas employment income of the previous tax year (Year 1).

For the rest of Year 2, J continues to have his UK salary of £10,000 a month and his relevant foreign earnings' [*sic*] of £5,000 a month paid into that same account. Both salaries are paid on the last day of each month. There are no further credits or debits from the account in Year 2.

J also writes two cheques to pay bills. These amounts are identified as being 15 October to buy a car and 3 February to pay for building work on his UK property. The final debit on the account (£100,000) is for the purchase of shares in a UK company. All three of these amounts are remittances from a mixed fund to which the rules in s809Q apply.

His UK salary is credited net of PAYE and NIC. His overseas salary is subject to a foreign tax deducted at source, and is credited net. His overseas dividends are also credited to the account net of overseas withholding taxes.

		Credit	**Debit**	**Balance**	**Category S809Q(4)**
Year 2	Balance b/f			£99,000	
30 Sept	UK salary (net of tax)	£10,000		£109,000	**Para (a)**
30 Sept	Overseas salary (net of tax)	£5,000		£114,000	**Para (f)**
31 Oct	UK salary	£10,000		£124,000	**Para (a)**
31 Oct	Overseas salary	£5,000		£129,000	**Para (f)**
30 Nov	UK salary	£10,000		£139,000	**Para (a)**
30 Nov	Overseas salary	£5,000		£144,000	**Para (f)**
31 Dec	UK salary	£10,000		£154,000	**Para (a)**
31 Dec	Overseas salary	£5,000		£159, 000	**Para (f)**
31 Jan	UK salary	£10,000		£169,000	**Para (a)**
31 Jan	Overseas salary	£5,000		£174,000	**Para (f)**
28 Feb	UK salary	£10,000		£184,000	**Para (a)**
28 Feb	Overseas salary	£5,000		£189,000	**Para (f)**
31 Mar	UK salary	£10,000		£199,000	**Para (a)**
31 Mar	Overseas salary	£5,000		£204,000	**Para (f)**
Year 3					
30 April	UK salary	£10,000		£214,000	**Para (a)**
30 April	Overseas salary	£5,000		£219,000	**Para (f)**

15 May	Dividend	£2,000		£221,000	**Para (g)**
31 May	UK salary	£10,000		£231,000	**Para (a)**
31 May	Overseas salary	£5,000		£236,000	**Para (f)**
30 June	UK salary	£10,000		£246,000	**Para (a)**
30 June	Overseas salary	£5,000		£251,000	**Para (f)**
30 June	Direct Debit to purchase UK shares		£150,000	£101,000	
3 July	Transfer to UK		£5,000	£96,000	

Note 1
The direct debit on 30 June (£150,000) is a remittance from a mixed fund. Applying the ordering rules in S809Q to the account **immediately before the transfer:**

Step 1 – Identify the "amount of transfer" in the relevant tax year (Year 3)		**£150,000**
Analyse mixed fund to identify the separate amounts of income, capital gains and capital present for the relevant tax year (Year 3) immediately before the date of the transfer	**Para (a**) Employment income (including UK employment income) not subject to a foreign tax	£30,000
	Para (f) Employment income subject to a foreign tax	£15,000
	Para (g) Relevant foreign income subject to a foreign tax	£2,000
Step 2 – Identify the earliest paragraph above for the relevant year (Year 3), which has an amount of income or gain in the mixed fund	**Para (a)**	£30,000
Step 3 Where the amount of the remittance is greater than the amount identified at Step 2 the amount remitted is treated as reduced by the amount identified in Step 2.		£150,000 less £30,000= £120,000

Step 4 - Find the next paragraph/amount for that tax year. In the order of preference listed above repeat Steps 2 and 3.		
Step 2 – Identify the earliest paragraph	**Para (f)**	£15,000
Step 3 - Where the amount of the remittance is greater		£120,000 less £15,000 = £105,000
Step 4 - Repeat Steps 2 and 3.		
Step 2 – Identify the earliest paragraph	**Para (g)**	£2,000
Step 3 - Where the amount of the remittance is greater		£105,000 less £2,000 = £103,000
At this stage all of the amounts credited to the account in Year 3 have been matched against remitted amounts. Income and capital of the next previous year (Year 2) must now be considered - so return to Step 1 for Year 2.		
Step 1 - Identify the separate amounts of income, capital gains and capital present for Year 2 before transfer	**Para (a)** Employment income (including UK employment income) not subject to a foreign tax	Year 1 – £10,000 Year 2 – £80,000
	Para (f) Employment income subject to a foreign tax	Year 1 - £5,000 Year 2 - £40,000
	Para (i) Capital	Year 2 - £69,000
Step 2 – Identify the earliest paragraph above for the relevant year (Year 2) , which has an amount of income or gain in the mixed fund	**Para (a)**	£80,000
Step 3 Where the amount of the remittance is greater than the amount identified at Step 2 the amount remitted is treated as reduced by the amount identified in Step 2.		£103,000 less £80,000 = £23,000
Step 4 - Find the next paragraph/amount for that tax year. In the order of preference listed above repeat Steps 2 and 3.		

Step 2 – Identify the earliest paragraph	**Para (f)**	£40,000
Step 3- If the amount is more than the [residual] "transfer amount", the whole of the remittance comes from that paragraph.		£23,000

The £150,000 transfer is therefore regarded as a remittance of:

£110,000	UK employment income	(within para a)
£38,000	relevant foreign income	(within para f)
£2,000	relevant foreign earnings	(within para g)

Note 2

The transfer on 3 July of £5,000 to meet daily living expenses will similarly be regarded as coming from the "earliest paragraph" in the mixed fund, which is paragraph (f) containing relevant foreign earnings from Year 2.

The result of this exercise is that:

- J's UK salary in Year 3 is deemed to have been brought to the UK first and is not a taxable remittance.
- Similarly all of his relevant foreign income and overseas employment income of Year 3 are treated as remitted to the UK and chargeable to tax at the appropriate rates of tax – allowing credit for foreign taxes charged on that same income as appropriate.

Reconciliation

The mixed fund still contains:

£69,000	capital (from the sale of shares in Year 2) together with
£12,000	relevant foreign earnings from Year 2, and
£10,000	UK employment income from Year 1
£5,000	relevant foreign earnings from Year 1
£96,000	

Remittances from mixed funds involving income/gains before 6 April 2008 - Example 4

The "mixed fund" rules in s809Q do not apply to amounts that are in an account before 6 April 2008 (FA2008/para 89).

M has lived in the UK for many years. He has paid UK tax on the remittance basis for all relevant tax years and has decided that he will do so again for 2008/-2009.

M has his UK salary paid into his overseas bank account. He also has a salary for overseas employment and his net salary for that work of £5,000 a month is paid into the account. Dividends from a shareholding in a foreign company are also paid into the account.

On 18 March M sold some of his foreign shares. He deposited the proceeds of £5,000,000 from the sale into his BVI account. This amount is made up of £4m capital and £1m gain (no deduction of foreign tax).

BVI Account:

		Credit	Debit	Balance	Note
Tax Year 2007-2008					
	Balance b/f			£47,000	1
31 Dec	UK salary (net of tax)	£10,000		£57,000	
31 Dec	Overseas salary (net of tax)	£5,000		£62,000	
3 Jan	Transfer to UK account		£5,000	£57,000	2
31 Jan	UK salary	£10,000		£67,000	
31 Jan	Overseas salary	£5,000		£72,000	
3 Feb	Transfer to UK account		£12,000	£60,000	2
15 Feb	Dividend	£2,000		£62,000	
29 Feb	UK salary	£10,000		£72,000	
29 Feb	Overseas salary	£5,000		£77,000	
3 March	Transfer to UK account		£8,000	£69,000	2
18 March	Sale of shares (£4m capital and £1m gain)	£5,000,000		£5,069,000	3
31 March	UK salary	£10,000		£5,079,000	
31 March	Overseas salary	£5,000		£5,084,000	
3 Apr	Transfer to UK account		£10,000	£5,074,000	2

Note 1
The balance brought forward of £47,000 is made up of £15,000 UK salary, £25,000 overseas salary and £7,000 overseas dividends all arising in, and credit during that tax year. M has paid the relevant amount of UK tax based upon his UK sources of income and the amounts of foreign income and gains that he has remitted to the UK.
Note 2
For tax years up to 5 April 2008, there are no statutory rules to determine what amounts remitted from "mixed funds" actually consisted of. Broadly HMRC practice was based on House of Lords decisions, in particular that of *Scottish Provident v Allan* (4 TC 409/591). In the Court of Exchequer, Lord McLaren said (page 419)

" ... unappropriated remittances ... must be dealt with according to the

> ordinary course of business, and these remittances must be presumed to be paid in the first place out of interest so far as they are income, and in the second place of principal or capital. I think that rule results from the fact that no prudent man of business will encroach upon his capital for investment when he has income uninvested lying at his disposal".

The House of Lords considered that the question of whether any amount of income had actually been received in the UK is essentially one of fact – of tracing in the first instance, or, where direct tracing proves to be impossible, of inference from the known facts.

The principle followed is, therefore, that in the absence of any evidence to the contrary, where capital and income have been paid into a single fund overseas so that they are no longer distinguishable, remittances to the UK out of the fund will be presumed to be income to the extent that there is income existing in the fund at the time that the remittance was made.

This is not correct: see appendix 3.

Where an overseas "mixed fund" contained an amount that has already suffered UK tax, for example UK salary dealt with under PAYE, the practice (*Sterling Trust v IRC* 12 TC 868) was that a taxpayer was entitled to say that he or she has remitted income which has already suffered UK tax (to the extent that such income exists in the fund) in priority to income which is assessable on the arising basis.

So to establish the taxable amount of remittances made in the example above in 2007-2008 the account must be analysed. In this case the analysis is straightforward. M has brought £49,000 to the UK between December 2007 and March 2008 to meet his day to day UK spending needs. Applying the *Sterling Trust v IRC* practice outlined above, the £35,000 can be regarded as remittances consisting solely of his UK salary that has already been taxed under PAYE. Because he has claimed the remittance basis of taxation in respect of his relevant foreign income or foreign earnings for 2007-2008 he has no further amount of UK tax to pay on these amounts that stay in the BVI account.

Note 3

Although not relevant in this example, for years up to 5 April 2008, where a remittance is made to the UK from a mixed fund into which the proceeds from the sale of an asset (such as a shareholding) has been paid the remittance contains a due proportion of any capital and of any capital gain arising from the disposal.

That is because, unlike income that can be identified separately, a capital gain is merely part of the money received from the sale and has no separate existence within that amount. See Capital Gains Manual CG25380 onwards (and CG25440 in particular).

Remittances from mixed funds involving income/gains before 6 April 2008 - Example 4a

Continuing from the example 4 above, on 5 April 2008 M's BVI account contains:

2007- 2008	UK salary	£20,000
	Overseas salary	£45,000
	Overseas dividends	£9,000
Sale of shares	Capital	£4,000,000
	Gain	£1,000,000

Tax Year 2008-2009		**Credit**	**Debits**	**Balance**	**S809Q(4)**	**Note**
6 April	Balance b/f			£5,074,000		
30 April	UK salary (net)	£10,000		£5,084,000	**Para (a)**	
30 April	Overseas salary (net)	£5,000		£5,089,000	**Para (f)**	
3 May	Transfer to UK account		£5,000	£5,084,000		1
15 May	Dividend	£2,000		£5,086,000	**Para (g)**	
31 May	UK salary	£10,000		£5,096,000	**Para (a)**	
30 May	Overseas salary	£5,000		£5,101,000	**Para (f)**	
30 June	UK salary	£10,000		£5,111,000	**Para (a)**	
30 June	Overseas salary	£5,000		£5,116,000	**Para (f)**	
30 June	Direct Debit		£100,000	£5,016,000		2

Credits Debits
Note 1
Applying the ordering rules in S809Q to the account **immediately before the transfer:**

Step 1 – Identify the "amount of transfer" in the relevant tax year (2008-09)		£5,000
Identify the separate amounts of income, gains and capital present for the relevant tax year (2008-09) immediately before the transfer	**Para (a)** Employment income not subject to a foreign tax	£10,000
	Para (f) Employment income subject to a foreign tax	£5,000

Step 2 – Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund	**Para (a)**	£10,000
Step 3 Where the amount of the remittance is less than the amount identified at Step 2 the amount remitted is treated coming entirely from that paragraph. There is no need to continue to step 4.		£5,000

The remittance is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income, so there is no taxable remittance of foreign income nor further tax to pay upon remittance.

Note 2

M decided to buy a residential property. He remits £100,000 to pay some legal fees for the purchase on 30 June. Although M considers that this amount has come from the sale of shares in 2007-2008 the ordering rules in s809Q require the remittance to be taken into account first against all income and gains of the year in which the remittance is made.

Step 1 – Identify the "amount of transfer" in the relevant tax year (2008-2009)		£100,000
Identify the separate amounts of income, gains and capital present for the relevant tax year (2008-09) immediately before the transfer	**Para (a)** Employment income (not subject to a foreign tax	£25,000
	Para (f) Employment income subject to a foreign tax	£15,000
	Para (g) Relevant foreign income subject to a foreign tax	£2,000
Step 2 – Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund	**Para (a)**	£25,000
Step 3 Where the amount of the remittance is greater than the amount identified at Step 2 the amount remitted is treated as reduced by the amount identified in Step 2.		£100,000 - £25,000 = £75,000
Step 4 - Find the next paragraph/amount for that tax year. In the order of preference listed above repeat Steps 2 and 3.		
Step 4 - In the order of preference listed above repeat Steps 2 and 3.		
Step 2 – Identify the earliest paragraph	**Para (f)**	£15,000

Step 3 - Where the amount of the remittance is greater		£75,000 less £15,000 = £60,000
Step 4 - In the order of preference listed above repeat Steps 2 and 3.		
Step 2	**Para (g)**	£2,000
Step 3		£60,000 less £2,000 = £58,000

At this stage all of the amounts credited to the account in 2008-09 have been matched against £100,000 remittance transfer in that year. But £58,000 has been brought to the UK that has not been "matched" under the s809Q rules (and cannot be matched because of FA2008/para89).

The remaining £58,000 is regarded as coming from the 2007-08 credits to the account. The ordering rules at section 809Q cannot be used, so instead the general principles outline in Note 2 of example 4 above will apply.

This £58,000 will usually be regarded as a remittance of M's income and is, first and foremost (Sterling Trust principle) his taxed income and then (Scottish Provident v Allan principle) any other income - that is his foreign employment income or dividends - as he selects.

However in this case M may equally be able to demonstrate that the remaining £58,000 comes from the proceeds of the sale of shares, as he particularly sold the shares in order to fund this house purchase. If that is the case, the remaining remittance will consist of £11,600 foreign chargeable gain (1/5 due proportion – see note 3 in example 4).

How is M to demonstrate this, given that the fund is mixed? I think this is a tentative admission that the HMRC "income first" approach is wrong.

Composition of mixed fund – debts - example

F, a remittance basis user, has a bank account in Jersey into which is paid both UK source (taxed) income and foreign income and gains. F makes transfers from the Jersey account to his UK account to meet his UK living expenses.

On 28 May, F acquires a loan from his Jersey bank that he uses to purchase an asset in Jersey for £200,000 – Note 3. He repays the loan from this account.

		Credit	Debit	Balance	Category S809Q(4)	See Note
Opening balance at 6 April	Clean capital from inheritance	£80,000		£80,000	i	

15 April	Relevant foreign income offshore dividend (untaxed)	£10,000		£90,000	d	
30 April	UK salary	£10,000		£100,000	a	
30 April	Relevant foreign income (Jersey bank interest)	£5,000		£105,000	d	
30 April	Overseas salary (not subject to foreign tax)	£5,000		£110,000	b	
3 May	Transfer to UK account		£5,000	£105,000		1
15 May	Relevant foreign income	£2,000		£107,000	d	
31 May	UK salary	£10,000		£117,000	a	
31 May	Overseas salary	£5,000		£122,000	b	
3 June	Transfer to UK account		£5,000	£117,000		2
28 June	Monthly payment - bank loan		£15,000	£102,000		3 and 4
30 June	UK salary	£10,000		£112,000	a	
30 June	Overseas salary	£5,000		£117,000	b	
3 July	Transfer to UK account		£5,000	£112,000		5
28 July	Monthly payment - bank loan		£15,000	£97,000		6
31 July	UK salary	£10,000		£107,000	a	
31 July	Overseas salary	£5,000		£109,000	b	
3 August	Transfer to UK account		£5,000	£102,000		7
15 August	Cheque – ZZZ Cars Ltd		£25,000	£77,000		8

28 August	Monthly payment - bank loan		£15,000	£62,000		9
31 August	Overseas salary	£5,000		£67,000	b	
31 August	UK salary	£10,000		£72,000	a	
3 Sept	Transfer to UK account		£5,000	£67,000		10

Note 1

Using the ordering rules at ITA07/s809Q, the remittance to the UK on 3 May is matched against the UK salary from that tax year credited to the account on 30 April, as this is the "earliest paragraph" of income or gains within the mixed fund.

Note 2

The remittance on 3 June is also matched against the UK salary from that tax year credited to the account before that date.

Note 3

The £200,000 used to pay for the assets is borrowed capital and is not in itself a remittance or an offshore transfer. However, subsequent payments of interest and capital used to repay the loan are offshore transfers.

Note 4

At the time immediately before the first repayment of the debt occurs on 28 June, the "mixed fund is composed as follows:

"Clean capital"	£80,000	
UK salary	£10,000	see note 4(a)
Relevant foreign earnings	£10,000	
Relevant foreign income	£17,000	
	£170,000	

The repayment of the monthly bank loan of £15,000 is an offshore transfer, consisting of an appropriate proportion of each kind of income within the mixed fund, that is:

Clean capital	£10,256
UK salary	£1,282
Relevant foreign earnings	£1,282
Relevant foreign income	£2,180
	£15,000

The property acquired by F using the loan is now regarded as containing this income.

Note 4(a)

Although £20,000 of F's UK salary has been credited to the account, £10,000 has already been remitted prior to 28 June (see Notes 1 and 2).

Note 5

The next remittance on 3 July is again £5,000 that is matched against the UK salary credited to the account before that date.

Note 6

At the time immediately before the repayment on 28 July, the "mixed fund" is composed as follows:

Clean capital	£69,744
UK salary	£13,718
Relevant foreign earnings	£13,718
Relevant foreign income	£14,820
	£112,000

The repayment of the monthly bank loan of £15,000 is an offshore transfer, consisting of an appropriate proportion of each kind of income within the mixed fund, that is:

Clean capital	£9,339
UK salary	£1,838
Relevant foreign earnings	£1,838
Relevant foreign income	£1,985
	£15,000

The property acquired by F is now regarded as containing this income.

Note 7

A further £5,000 remittance on 3 August is again matched against UK salary.

Note 8

The payment of £25,000 to ZZZ Cars is to buy a car and is a taxable remittance. Immediately before the transfer the mixed fund is composed as follows:

Clean capital	£60,405
UK salary	£16,880
Relevant foreign earnings	£16,880
Relevant foreign income	£12,835
	£107,000

This £25,000 remittance is matched firstly against UK salary (£16,880), then against relevant foreign earnings (£8,120).

Note 9

At the time immediately before the repayment on 28 August, the mixed fund is composed as follows:

Clean capital	£60,405
UK salary	£nil
Relevant foreign earnings	£8,760
Relevant foreign income	£12,835
	£82,000

The repayment of the monthly bank loan of £15,000 is an offshore transfer, consisting of an appropriate proportion of each kind of income within the mixed fund, that is:

Clean capital	£11,049
Relevant foreign earnings	£1,603
Relevant foreign income	£2,348
	£15,000

Note 10

The fifth remittance on 3 September is again £5,000 that is matched against the UK salary from that tax year credited to the account before that date.

The account now contains £77,000, being

Clean capital	£49,356
UK salary	£5,000
Relevant foreign earnings	£12,157
Relevant Foreign Income	£10,487

For the purposes of this example, assume that on 8 September F wins the Jersey local lottery ("clean capital") and uses his winnings to pay off the outstanding loan.

Three years later, F brings the property acquired with the loan to the UK. The property is a mixed fund, and it is regarded as containing the income and capital used to pay off the loan, that is:

UK salary	£3,120
Relevant foreign earnings	£4,723
Relevant foreign income	£6,513
Clean capital.	£185,644

F has remitted foreign income of £11,236.

The moral which follows from these examples is the imperative of not mixing funds of different types of income or gains, so far as possible.

10.30 Composition of mixed fund

10.30.1 *Finding the income and capital for the year*

Step 1 provides:

> *For each of the categories of income and capital in paragraphs (a) to (i) of subsection (4), find (applying section 809R) the amount of income or capital of the individual for the relevant tax year in the mixed fund immediately before the transfer.*

Income for any year is not difficult to identify, for the tax system often requires one to attribute income to a tax year. Chargeable gains for any year are not difficult to identify, for they accrue on a particular date. What about "other capital" falling within category (i)? That would include:

(1) gifts, inheritance;
(2) borrowed money;
(3) chargeable event gains on a surrender of a life policy.

It is considered these must be capital for the year in which it is received.
The rules do not work in the most pro-Revenue way possible. Suppose:

Year 1: T uses RFI to purchase a policy for £1m.

Year 5: T surrenders the policy for £2m and realises a chargeable event gain of £1m (taxable on the arising basis). T remits £1m.

The £1m remitted is category (i) “other capital” of year 5, so there is no further charge on the remittance.

10.30.2 *Derived property*

Section 809R ITA provides:

> **809R Section 809Q: composition of mixed fund**
> (1) This section applies for the purposes of step 1 of section 809Q(3) (composition of mixed fund).
> (2) Treat property which derives wholly or in part (and directly or indirectly) from an individual’s income or capital for a tax year as consisting of or containing that income or capital.

Section 809R(3) provides:

> If a debt relating (wholly or in part, and directly or indirectly) to property is at any time satisfied (wholly or in part) by—
> (a) an individual’s income or capital for a tax year, or
> (b) anything deriving (directly or indirectly) from such income or capital,
>
> from that time treat the property as consisting of or containing the income or capital if and to the extent that it is just and reasonable to do so.

The drafter has given up here.

10.31 Offshore transfer mixed fund rule

Section 809R(4) ITA provides:

> Treat an offshore transfer from a mixed fund as containing the appropriate proportion of each kind of income or capital in the fund immediately before the transfer.
> "The appropriate proportion" means the amount (or market value) of the transfer divided by the market value of the mixed fund immediately before

the transfer.

I refer to this as **"the offshore transfer mixed fund rule".**

"Transfer" must have the same meaning as in s.809Q so it includes any type of payment, whether or not made for consideration.

10.31.1 *Meaning of "offshore transfer"*

Section 809R(5) defines "offshore transfer":

> A transfer from a mixed fund is an "offshore transfer" for the purposes of subsection (4) if and to the extent that section 809Q does not apply in relation to it.

So far the definition seems clear. One must ask whether s.809Q applies. Section 809Q applies if remittance condition A applies, that is (in short), if a sum is received in the UK by a relevant person. A transfer to a UK bank account is an onshore transfer. So a transfer to a foreign account appears to be an offshore transfer. But suppose:
(1) year 1: a sum is transferred to a foreign account ("the first transfer")
(2) year 2: the sum transferred to a UK account ("the second transfer").
It appears that in year 1 the first transfer is not an offshore transfer, but in year 2 it becomes one.[89] To avoid this result, s.809R(6) ITA provides:

> Treat a transfer from a mixed fund as an "offshore transfer" (and section 809Q as not applying in relation to it, if it otherwise would do) if and to the extent that, at the end of a tax year in which it is made—
> (a) section 809Q does not apply in relation to it, and
> (b) on the basis of the best estimate that can reasonably be made at that time, section 809Q will not apply in relation to it.

If *both* condition (a) and (b) of this subsection are satisfied, there are two consequences:
(1) One must treat the transfer as an offshore transfer.
(2) One must treat section 809Q as not applying in relation to it, if it otherwise would do.

89 Because remittance condition A is met, and (assume) the property received in the UK derives from the first transfer.

Unless both condition (a) and (b) are satisfied, this subsection does not apply.

The condition in subsection (6)(a) is clear enough. One asks whether s.809Q applies at the end of the tax year. Eg if I transfer £100 from a mixed fund to a new offshore account on 6th April 2008, and the money is still there on 5th April 2009, this condition is met.

Subsection (6)(b) is a challenge. At the end of the tax year, one must ask whether one can say that s.809Q will not apply in relation to the transfer. In relation to some transfers one can say with certainty that s.809Q will not apply. If the transferor draws a sum from a mixed fund to pay for his dinner outsider the UK, then s.809Q will not apply to because nothing will be received in the UK. That is an offshore transfer. If a person transfers a sum to an offshore account and does expect to spend them in the UK that is an offshore transfer.

10.31.2 *Problematic transfer*

I use the term "**problematic transfer**" (for reasons which will become obvious) to describe a transfer made in the following circumstances (by no means unusual):

(1) In year 1 T transfers a sum from a mixed fund to an account outside the UK.
(2) At the end of year 1 the transferred sum is not received in the UK.
(3) T cannot say at the end of the year 1 that "section 809Q will not apply in relation to" the problematic transfer. This may be because:
 (a) At the end of year 1, T does expect to spend the sum in the UK but not until a later year, say, year 5; or
 (b) T does not know whether he intends to remit the sum to the UK.

At the end of year 1, the problematic transfer is not an onshore transfer (because s.809L does not apply). It is an offshore transfer within the definition in s.809R(5). Admittedly it is not within subsection 809R(6) but that subsection does not stop any transfer being an offshore transfer, if applicable it treats non-offshore transfers as offshore transfers.

(4) Suppose in a later year (say year 5) T transfers the sum to the UK. I refer to this as its **"subsequent remittance**."

On one view, the problematic transfer changes status at the time of its subsequent remittance and becomes an onshore transfer. That is workable if in the meantime T has not made any other onshore transfers from the mixed fund. It is not workable if in the meantime T has made other transfers from the mixed fund, because:

(1) T needed to know at the time what income or gains those other transfers included.
(2) There cannot possibly be a recomputation of the tax effect of the other transfers in earlier years on the basis that the problematic transfer has turned out to be an onshore transfer after all. I think that is obviously impractical, but for good measure it is also inconsistent with s.809R(9) ITA which provides:

> If section 809Q applies in relation to more than one transfer from a mixed fund, when undertaking step 1 in relation to the second or any subsequent transfer take into account the effect of step 2 of section 809Q(3) (composition of transfer) as it applied in relation to each earlier transfer.

It is almost impossible to make a coherent tax regime out of this intractable statutory material, which is not surprising given the way in which it was enacted. I think the best solution is to say that s. 809Q(6)(b) is misconceived, that a problematic transfer is only an onshore transfer if s. 809Q applies to it in the year of the transfer. If at the end of the year it is an offshore transfer, its status does not change later.

The alternative view is that the problematic transfer does change its status and becomes an onshore transfer, on the occasion of its subsequent remittance. One carries through the implications for tax purposes so far as that is possible, so the result if that tax is charged as if the questionable transfer was made after the subsequent transfers.)

If that were so, another issue arises. Suppose when asked whether the sum will be remitted, T says (as he may well say) that he will remit it if the offshore transfer, The question whether a sum will be remitted to the UK may depend on the tax position, ie if it represents an offshore transfer it will be remitted and if it represents an onshore transfer it will not. It is therefore impossible to answer the s809R(6)(b) question, whether the sum will be remitted, on the view that a problematic transfer becomes an onshore transfer when remitted; for if it is an offshore transfer it will be remitted (and so is an onshore transfer) but if it is an onshore transfer it will not be remitted (and so is an offshore transfer.)

10.31.3 *HMRC explanation*

EN Clause 23 Schedule 7 Remittance Basis Amendments 463 to 481 explains s.809R(4) ITA:

> 7. Amendment 465 introduces a new subsection [4], dealing with cases where transfers are made wholly offshore. The new rules aim to ensure that where a transfer is made offshore from fund A to fund B, and remittances to the UK are then made from fund A or fund B, the normal ordering rules for mixed funds apply, as they would have done had the transfer to Fund B not been made before the remittance.

In fact the offshore transfer mixed fund rule does nothing of the sort. The EN continues:

> 8. So if fund A consisted of equal amounts of untaxed income and capital, and half the fund was transferred to fund B, it cannot be argued that fund A or B consisted solely of capital, and remittances from fund A or B were not therefore taxable. Instead, where there is an offshore transfer, so that the normal mixed fund ordering rules do not apply, fund B is to be treated as containing the same proportion of the different categories of income and capital as the original fund, in relation to the amount transferred.

10.31.4 HMRC Examples

The RDR Manual provides:

> **Composition of mixed funds – offshore transfers - example 1**
> Ahmid, a remittance basis user has a bank account in the Isle of Man into which is paid both UK source (taxed) income and his foreign income and gains. A makes regular transfers from this account to his UK account to meet his UK living expenses.

		Credit	Debit	Balance	Category S809Q(4)	Note
10 April	XYZ (CI) Ltd – proceeds from sale of shares	£1,000,000		£1,000,000	e	1
15 April	Relevant foreign income Offshore dividend	£10,000		£1,010,000	g	
30 April	UK salary	£10,000		£1,020,000	a	2
30 April	Bank interest	£5,000		£1,025,000	d	
30 April	Overseas salary (net of tax)	£5,000		£1,030,000	f	
3 May	Transfer to UK account		£5,000	£1,025,000		3
15 May	Offshore dividend	£2,000		£1,027,000	g	
31 May	UK salary	£10,000		£1,037,000	a	
31 May	Overseas salary (net of tax)	£5,000		£1,042,000	f	
31 May	ABC (IoM) Ltd – purchase of shares in foreign company		£1,000,000	£42,000		3
3 June	Transfer to UK account		£5,000	£37,000		4
30 June	UK salary	£10,000		£47,000	a	
30 June	Overseas salary (net of tax)	£5,000		£52,000	f	
3 July	Transfer to UK account		£5,000	£47,000		5
31 July	UK salary	£10,000		£57,000	a	
31 July	Overseas salary (net of tax)	£5,000		£62,000	f	

3 Aug	Transfer to UK account		£5,000	£57,000		6
15 Aug	Cheque – ZZZ Cars Ltd London		£25,000	£32,000		7

Note 1

The sale price of the shares includes a gain over the original purchase price of £150,000 that has not been taxed. The purchase was made long before 6 April 2008 and was made using accumulated foreign income and gains which were treated as clean capital.

The transitional provisions mean that it is not possible to apply the "mixed fund" rules to the £850,000 used to buy the shares.

Note 2

Using the ordering rules at ITA07/s809Q(1), the remittance to the UK on 3 May is matched against the UK salary from that tax year credited to the account on 30 April, as this is the "earliest paragraph" of income or gains within the mixed fund.

Working this through:

The £5,000 transfer to the UK on 3 May is a "transfer" from a mixed fund within section 809Q. Applying the ordering rules in that section, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for each tax year immediately before the date of the transfer:

Para (a)	employment income	£10,000
Para (d)	RFI	£5,000
Para (e)	Chargeable gains	£150,000
Para (f)	Earnings subject to a foreign tax	£5,000
Para (g)	RFI subject to tax	£10,000
Para (i)	Income or capital not within another paragraph	£850,000

The remittance is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income. Although money has been brought into the UK, there is no taxable remittance as the money has already been taxed.

Note 3

The purchase of shares on 31 May is an "offshore transfer"; by the end of the tax year the shares purchase have not, nor on best estimate are they likely to be, a remittance transfer so that s809Q applies.

The account is treated as including the amounts of foreign income and gain that were present immediately before the transfer (ITA07/s809R(4)). The transfer has no effect on the amount remitted in the current tax year but may need to be taken into account in a later tax year.

Immediately before the offshore transfer the mixed fund consists of:

Para (a)	employment income	£15,000
Para (d)	RFI	£5,000
Para (e)	Chargeable gains	£150,000
Para (f)	Earnings subject to a foreign tax	£10,000
Para (g)	RFI subject to tax	£12,000
Para (i)	Income or capital not within another paragraph	£850,000
		£1,042,000

The offshore transfer consists of an appropriate proportion of each kind of income, gain or capital, within the mixed fund, that is:

Para (a)	employment income	£14,396
Para (d)	RFI	£4,798
Para (e)	Chargeable gains	£143,953
Para (f)	Earnings subject to a foreign tax	£9,597
Para (g)	RFI subject to tax	£11,517
Para (i)	Income or capital not within another paragraph	£815,739
		£1,000,000

Note 4

The £5,000 transfer on 3 June to the UK is a "transfer" to the UK from a mixed fund, and is within s809Q(1). Applying the ordering rules in that section, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital present for each tax year immediately before the date of the transfer:

Para (a)	employment income	£604
Para (d)	RFI	£202
Para (e)	Chargeable gains	£6,047
Para (f)	Earnings subject to a foreign tax	£403
Para (g)	RFI subject to tax	£483
Para (i)	Income or capital not within another paragraph	£34,261

The transfer is regarded as coming from each of the paragraphs in order; that is £604 from para (a), and a taxable remittance of £4,396, being £202 from para (d) and £4,194 from para (e).

Note 5 and 6

Both of these £5,000 transfers are to the UK. There have been credits to the fund between the last transfer (note 4) and this transfer and the fund now contains some employment income (para a) and additional amounts of foreign earning subject to foreign tax (para f) in addition to the residue following the last transfer.

The £5,000 transfers made on 3 July and 3 August are regarded as coming from the earliest paragraph' of income, that is para (a) – £10,000 of UK employment income credited to the account on 30 June.

Note 7

The cheque remittance on 15 August is £25,000. This amount was used to buy a car from a UK company. This is also a remittance within s809Q. Immediately before the transfer the mixed fund consists of:

Para (a)	employment income	£10,000
Para (d)	RFI	£nil
Para (e)	Chargeable gains	£1,853
Para (f)	Earnings subject to a foreign tax	£10,403
Para (g)	RFI subject to tax	£483
Para (i)	Income or capital not within another paragraph	£34,261

The cheque remittance is regarded as coming from each of the paragraphs in order; that is £10,000 from para (a), £1,853 from para (e) and £10,403 from para (f), £483 from para (g) and £2,261 from para (i).

The remaining £32,000 at 15 August is also within para (i)

Example 1(a) – Transfer to another account To continue the IoM account in example 1:

Date		**Debit**	**Credit**	**Balance**	**Category (S809Q(4))**	**Note**
	Balance b/f			£32, 000		
31 Aug	Overseas salary (net of tax)	£5,000			f	
31 Aug	UK salary	£10,000			a	
3 Sept	Transfer to UK account		£5,000			1
15 Sept	Cheque – XYZ Travel Services (CI) Ltd		£10,000			2
30 Sept	Overseas salary (net of tax)	£50,000			f	
30 Sept	Overseas Dividend	£350,000			g	
30 Sept	UK salary	£180,000			a	
3 Oct	Transfer to UK account		£5,000			3
15 Oct	Transfer to Swiss bank account		£350,000			4

Note 1

Immediately before the transfer on 3 September the mixed fund contained:

Para (a)	employment income	£10,000
Para (f)	Earnings subject to a foreign tax	£5,000
Para (i)	Income or capital not within another paragraph	£32,000

The transfer is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income. Although money has been brought into the UK, there is no taxable remittance as the money has already been taxed,

Note 2

The next payment from the account is £10,000 for the family holiday flights to the USA. The full payment is a remittance because the service provided is in the UK – the flights begin or end in London.

The transfer is regarded as coming from each of the paragraphs in order; that is £5,000 from para (a) and a taxable remittance consisting of £5,000 from para (f).

Note 3

Immediately before the remittance on 3 October the mixed fund contained:

Para (a)	employment income	£180,000
Para (f)	Earnings subject to a foreign tax	£50,000
Para (g)	RFI	£350,000
Para (i)	Income or capital not within another paragraph	£32,000

The transfer is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income.

Note 4

The transfer of £350,000 to a new Swiss bank account is an offshore transfer. Immediately before the offshore transfer on 15 October the IoM bank account (mixed fund) is regarded as containing:

Para (a)	employment income	£175,000
Para (f)	Earnings subject to a foreign tax	£50,000
Para (g)	RFI	£350,000
Para (i)	Income or capital not within another paragraph	£32,000
		£607,000

The offshore transfer consists of an appropriate proportion of each kind of income, gain or capital, within the mixed fund, that is:

Para (a)	employment income	£100,906
Para (f)	Earnings subject to a foreign tax	£28,830
Para (g)	RFI	£201,812
Para (i)	Income or capital not within another paragraph	£18,452

The Swiss bank account is another "mixed fund", containing the income, gains and capital of the transferred amount. Assuming nothing else is added or taken away from to the Swiss account in the interim, if in a couple of years time A decides to remit £120,000 to the UK from his Swiss bank account, the same ordering rules will apply to the Swiss fund, so the remittance is regarded as consisting of £100,906 from para (a) and £19,094 from para (f).

Composition of mixed funds – offshore transfers – Example 2

L, a remittance basis user, opens a bank account in Bermuda into which is paid both UK source (taxed) income and her foreign income and gains. L makes a few transfers from this account to her UK account to meet UK living expenses. She also transfers money from this account to her other offshore account in Jersey, as well as using it for several offshore purchases.

Account 1 Bermuda

		Credit	Debit	Balance	Category s809Q(4)	Note
Year 1						
15 Jan	Capital	£1,000,000		£1,000,000	i	1
30 Jan	UK salary	£10,000		£1,010,000	a	
30 Jan	Bank interest	£5,000		£1,015,000	d	
30 Jan	Overseas salary (net of tax)	£5,000		£1,020,000	f	
3 Feb	Transfer to UK account		£5,000	£1,015,000		2
28 Feb	Dividend	£2,000		£1,017,000	g	
28 Feb	UK salary	£10,000		£1,027,000	a	
28 Feb	Overseas salary	£5,000		£1,032,000	f	
3 March	Purchase of shares in foreign company		£800,000	£232,000		3
10 March	Transfer to UK account		£5,000	£227,000		4
31 March	UK salary	£10,000		£237,000	a	
31 March	Overseas salary (net of tax)	£5,000		£242,000	f	
2 Apr	Transfer to UK account		£5,000	£237,000		5
Year 2						
30 April	UK salary	£10,000		£247,000	a	
30 April	Overseas salary (net of tax)	£5,000		£252,000	f	

3 March	Transfer to UK account		£5,000	£247,000		6
15 March	Transfer to UK account		£100,000	£147,000		7
31 May	UK salary	£10,000		£157,000	a	
31 May	Overseas salary (net of tax)	£5,000		£162,000	f	
8 June	Transfer – A2Z travel services		£20,000	£142,000		8

Year 1

Note 1

The £1,000,000 credited to the account on 15 Jan was inherited under L's great aunt's will, and is "clean" capital.

Note 2

The £5,000 transfer to the UK on 3 May is a "remittance" from a mixed fund within section 809Q(1). Applying the ordering rules in that section, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for each tax year immediately before the date of the transfer:

Para (a)	employment income	£10,000
Para (d)	RFI	£5,000
Para (f)	Earnings subject to a foreign tax	£5,000
Para (i)	Inherited capital	£1,000,000

The remittance is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income, so there is no taxable remittance of foreign income nor further tax to pay upon remittance.

Note 3

The purchase of shares on 3 March (£800,000) is an "offshore transfer". By the end of the tax year the shares purchased have not been sold, brought to the UK or otherwise used so that s809Q applies.

The account is treated as including the amounts of foreign income and gain that were present immediately before the transfer (ITA07/s809R(4)). The transfer has no effect on the amount remitted in the current tax year but may need to be taken into account in a later tax year.

Immediately before the offshore transfer the mixed fund consists of:

Para (a)	Employment income	£15,000
Para (d)	Relevant foreign income	£5,000
Para (f)	Earnings subject to a foreign tax	£10,000
Para (g)	Relevant foreign income subject to tax	£2,000
Para (i)	Inherited capital	£1,000,000
		£1,032,000

The "offshore transfer" (the shares purchase) consists of an appropriate proportion (100/129) of each kind of income, gain or capital, within the mixed fund, that is:

Para (a)	employment income	£11,628
Para (d)	RFI	£3,876
Para (f)	Earnings subject to a foreign tax	£7,752
Para (g)	RFI subject to tax	£1,550
Para (i)	Income or capital not within another paragraph	£775,194
		£800,000

Note 4

The £5,000 transfer to the UK on 10 March is a "remittance" from a mixed fund within section 809Q(1). Applying the ordering rules in that section, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for each tax year immediately before the date of the transfer:

Immediately before the transfer to the UK the mixed fund consists of:

Para (a)	employment income	£3,372
Para (d)	RFI	£1,124
Para (f)	Earnings subject to a foreign tax	£2,248
Para (g)	RFI subject to tax	£450
Para (i)	Income or capital not within another paragraph	£224,806
		£232,000

The remittance is regarded as coming from the "earliest paragraph", that is para (a), £3,372, para (d) £1,124 and para (f) £504. Of this amount, £1,124 and £504 are taxable remittances.

Note 5

The next remittance on 2 April is again £5,000. Two further amounts have been credited to the account which now consists of

Para (a)	employment income	£10,000
Para (f)	Earnings subject to a foreign tax	£6,744
Para (g)	RFI subject to tax	£450
Para (i)	Income or capital not within another paragraph	£224,806

The remittance is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income, so there is no taxable remittance of foreign income nor further tax to pay upon remittance.

The account now consists of:

Para (a)	employment income	£5,000
Para (f)	Earnings subject to a foreign tax	£6,744
Para (g)	RFI subject to tax	£450
Para (i)	Income or capital not within another paragraph	£224,806
		£237,000

At the end of the tax year, L has made taxable remittances of: £1,628 (para (d) £1,124 and para (f) £504). She has also made two offshore transfers:

Year 2

At the start of the next tax year, L continues to make remittances to the UK from the overseas account. The "mixed fund" rules mean that income and gains of a tax year are treated in priority to income and gains of a previous year.

Note 6

The £5,000 transfer to the UK on 3 May is a "remittance" from a mixed fund within s809Q(1). Applying the ordering rules in that section, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for tax Year 2 immediately before the date of the transfer:

Para (a)	employment income	£10,000
Para (f)	Earnings subject to a foreign tax	£5,000

The remittance is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income, so there is no taxable remittance of foreign income nor further tax to pay upon remittance.

Note 7

On 15 May, L transfers £100,000 to her UK bank account. This is a "remittance" from a mixed fund within section 809Q(1).

Applying the ordering rules section 809Q, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for tax Year 2 immediately before the date of the transfer:

Para (a)	employment income	£5,000
Para (f)	Earnings subject to a foreign tax	£5,000

So £10,000 of the transfer comes from these two paragraphs of Year 2 income. The outstanding balance of £90,000 must be identified by applying the ordering rules section 809Q, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for tax Year 1 immediately before the date of the transfer:

Para (a)	employment income	£5,000
Para (f)	Earnings subject to a foreign tax	£6,744
Para (g)	RFI subject to tax	£450
Para (i)	Income or capital not within another paragraph	£224,806

So the remaining £90,000 of the transfer will regarded as consist of monies from para (a) £5,000, Para (f) £6,744, Para (g) £450 and Para (i) £77,806 from Year 1.

The mixed fund now consists of:

Para (i)	Income or capital not within another paragraph	£147,000

10.32 Mixed fund anti-avoidance rule

Section 809S ITA provides:

809S Section 809Q: anti-avoidance

> (1) This section applies if, by reason of an arrangement[90] the main purpose (or one of the main purposes) of which is to secure an income tax advantage or capital gains tax advantage, a mixed fund would otherwise be regarded as containing income or capital within any of paras (f) to (i) of section 809Q(4).
> (2) Treat the mixed fund as containing so much (if any) of the income or capital as is just and reasonable.

I refer to this as "**the mixed funds anti-avoidance rule**".

IT advantage and CGT advantage have the standard (wide) definitions.[91] The terms are not limited to tax avoidance in the strict sense.

Section 809S is clearly intended to override the offshore mixed fund transfer rule although this is nowhere expressly stated.[92]

Suppose:

(1) T has a mixed fund containing £2m, 50% income and 50% capital.
(2) T transfers £1m, half the amount, to another account (an offshore transfer). T intends to keep that amount offshore.
(3) T then remits the funds in the first account to the UK.

Applying the offshore transfer mixed fund rule the first account, which is remitted, consists of 50% income and capital, so on remittance 50% of the sum received is tax free. In the absence of the offshore transfer, the whole

90 Section 809S(3) ITA contains the usual (unnecessary) commonsense definition of "arrangement":

> "'Arrangement' includes any scheme, understanding, transaction or series or transactions (whether or not enforceable)."

91 Section 809S provides:

> "(4) "Income tax advantage" has the meaning given by section 683.
> (5) "Capital gains tax advantage" means—
> (a) a relief from capital gains tax or increased relief from capital gains tax,
> (b) a repayment of capital gains tax or increased repayment of capital gains tax,
> (c) the avoidance or reduction of a charge to capital gains tax or an assessment to capital gains tax, or
> (d) the avoidance of a possible assessment to capital gains tax."

92 The mixed funds anti-avoidance rule could also override the *onshore* transfer mixed fund rule, but it is not likely ever to be just and reasonable to substitute any other set of rules.

of the £1m remitted would have been subject to income tax. The offshore transfer is an arrangement which secures an IT advantage. Assuming this was one of the main purposes, s.809S applies.

One then has to ask what is "just and reasonable". The drafter has given up here and left the courts to sort it out. One might say that it is reasonable to apply the pre-2008 mixed fund regime. That can hardly be described as unjust or unreasonable. But it is considered that the expression "just and reasonable" should be construed in accordance with the policy of the onshore transfer mixed fund rule. So an arrangement of the kind discussed above would be set aside and it would be just and reasonable to raise tax as if the offshore transfer had not been made. To put it another way, it is just and reasonable that transfers whose main purpose is to obtain a tax advantage should not do so.

If that were wrong, what would happen if there were a second transfer from the first account: in this way one could reduce the income element of any mixed fund to a relatively small sum by a series of offshore transfers.

10.32.1 *Scope of mixed funds anti-avoidance rule*

The mixed fund anti-avoidance rule applies only if the mixed fund contains income or capital within mixed fund categories (f) to (i). So if a mixed fund consisted of (say) RFI within category (d) and chargeable gains within category (e), the anti-avoidance provision does not apply. This is a little surprising and it might be that s.809S(1) contains a typographical error, (f) being a slip for (a). But it is not obvious that there has been an error, so a court should construe the section to mean what it says. In practice the point is not so important as a mixed fund will usually contain some item within categories (f) to (i).

10.33 Remittance of part of funds transferred

Section 809Q(8) ITA provides:

> If section 809Q applies in relation to part of a transfer, apply that section in relation to that part before applying subsection (4) in relation to the rest of the transfer.

10.34 Mixed funds of third parties

So far we have considered the ITA mixed fund regime where an individual transfers from a mixed fund containing his own income or gains. The position is more complex when a third party is involved. This may arise in (at least) the following four circumstances:

(1) A gains accrues to non resident company within s.13 TCGA so that a s.13 deemed gain accrues to an individual participator taxable on the s.13 remittance basis. There is a tax charge if the company remits its gain to the UK. What if that gain forms part of a mixed fund (ie the gain is mixed with other funds of the company)?
(2) Income arises to a person abroad within s.720, so that s.720 deemed income arises to an individual transferor, taxable on the s.720 remittance basis. There is in principle a tax charge if the person abroad remits its income to the UK. What if that income forms part of a mixed fund (ie the income is mixed with other funds of the person abroad)?

It is suggested that the ITA mixed fund regime does apply in these two circumstances. Step 1 of s.809Q(3) requires us to find the income or gain of the "individual" but the funds in the hands of the third person are derived (or are treated as derived) from the income or gains of the individual, so applying s.809R(2) ITA the funds in the hands of the third party are treated as consisting of that income or capital. This view may favour the taxpayer, particularly for a company which is within s.720 but not s.13, or for a company which is within s.13 but not s.720.

(3) Income or gains accrue to an individual and the individual gives the income or gains to a relevant person. There is a tax charge if the relevant person remits the gifted funds to the UK. What if the income or gains form part of a mixed fund (ie the income or gains are mixed with other funds of the relevant person)?
(4) An individual makes a gift of an asset to a relevant person, on which a deemed gain arises. The asset is treated as derived from that gain and there is a tax charge if the asset is remitted to the UK. What if the asset forms part of a mixed fund (i.e. the asset is mixed with other funds of the relevant person)?

If the relevant person is not UK resident, the ITA mixed fund regime could apply. If the relevant person is UK resident, there is a problem. Suppose

(1) T gives income ("T's income") to R.
(2) R mixes T's income with gains of R (accruing in the same year.)
(3) R remits part of the mixed fund.

Has R remitted T's income or R's gains? It is in R's interest to argue that he has remitted T's income and in T's interest to argue that R has remitted R's gains. It is tentatively suggested that R has remitted T's income first.

10.35 Commencement of ITA mixed fund regime

Para 89 Sch 7 FA 2008 provides:

> Sections 809Q to 809S of ITA 2007 (transfers from mixed funds) do not apply for the purposes of determining whether income or chargeable gains for the tax year 2007-08 or any earlier tax year are remitted to the UK (or the amount of any such income or chargeable gains so remitted).

Suppose:

(1) A mixed fund consists only of pre-2008 income/gains (no post 2008 income/gains).
(2) A transfer from that fund is made after 2008.

One needs to determine what part of that fund is remitted to the UK. I think this means that one disregards the ITA mixed fund regime (and instead applies the pre-2008 mixed fund regime).[93]

Suppose:

(1) A mixed fund includes pre-2008 income/gains and post 2008 income/gains.

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93 It does not mean that one disregards the ITA mixed fund regime (and instead applies the pre-2008 mixed fund regime) in ascertaining whether a pre-2008 transfer from a mixed fund constituted income/gains? (This question arises in order to identify the ingredients of the mixed fund for post-2008 transfers.) First my view is the more natural reading. Second, the alternative view would require an individual to classify the constituents of a mixed fund held at 6/4/08 by date and by the nine mixed fund categories, going back without limit of time. Records in many cases will not exist.

(2) A transfer from that fund is made after 2008.

One needs to determine what part of that fund is remitted to the UK. The analysis comes in two stages.

(1) First, one has to determine whether the remittance consists of pre-2008 or post-2008 income/gains.
(2) (a) If the remittance consists of pre-2008 income/gains, one applies the pre-2008 mixed fund regime to identify what is remitted.
    (b) If the remittance consists of post-2008 income/gains, one applies the ITA mixed fund regime to determine what is remitted.

Which set of rules apply at stage 1? The ITA mixed fund regime raises difficult transitional issues which this statutory provision does not properly address, leaving HMRC, taxpayers and the courts to sort it out as best they can. It is tentatively suggested that one applies the ITA mixed fund regime so far back as 2008/09 and then the pre-2008 mixed fund regime. This is the approach taken in HMRC's examples in the RDR Manual.

10.36 From which fund is remittance made?

In *Duke of Roxburghe's Executors v IRC* 20 TC 711 a taxpayer received and held offshore:

(1) income subject to UK tax on an arising basis ("taxed income");[94] and
(2) foreign income which qualified for the remittance basis, and which was therefore taxed if remitted ("untaxed income").

These were wisely held in separate accounts in one bank and so a remittance out of the taxed income account would not have been taxable. The taxpayer correctly directed the bank to make a remittance to the UK out of her taxed income account. Unfortunately the bank made a remittance out of the wrong account, so the sum remitted could (largely)

94 Being foreign source income of a class not then qualifying for the remittance basis and so subject to UK income tax on an arising basis.

be traced to untaxed income!

The Special Commissioners applied a tracing principle. The sum remitted was traced to taxed income, as to part; but the balance was traced to untaxed income, and so there was a tax charge on this remitted amount. The Court of Session surprisingly reversed this decision, on two alternative grounds. The first ground identified the sum remitted as taxed income because the taxpayer had *intended* the remittance to come out of taxed income:

> the Duchess was entitled to have the remittance debited against any fund belonging to her and under her control and that she did so effectually by the *instructions* to debit it against money not derived from the [untaxed] income.[95]

The second ground was that a remittance out of a mixed fund with taxed and untaxed income is necessarily to be treated as out of the taxed income.[96] The intention of the taxpayer is irrelevant. Lord Normand and Lord Fleming inclined to this view, without deciding it; Lord Moncrieff based his decision on this view. The second ground is now subject to the ITA mixed fund regime, but the first remains good law.

HMRC agree. The RDR Manual provides:

> *Bank Errors and Mistakes*
> Where a bank acts contrary to express instructions by an account holder, and that mistake inadvertently results in a taxable remittance to the UK by the account holder, the account holder and the bank may alter the transaction in line with the original instructions given.
> If the bank does this HMRC will treat the earlier [mistaken] transaction as not having taken place and the new transaction as the being the original transaction in looking at whether there has been a taxable remittance from that account.

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95 Lord Normand at p.726 (emphasis added). This was also the view of Lord Fleming who expressed himself in similar words: "I base my decision ... on the ground that it was the legal right of the Duchess to make the appropriation against any particular fund belonging to herself, and that in law she made that appropriation when she directed the Bank making the remittance to charge it against her funds in their hands which had already borne British Income Tax." (p.732).

96 There was an exception if very unusually there is something in the substance (as opposed to book-keeping) to show the contrary, but it is not now necessary to pursue this.

10.37 Remittance when ITA mixed fund regime does not apply

Suppose an individual holds in one mixed fund:

(1) income which is subject to foreign tax and qualifies for UK double tax relief; and
(2) income taxable subject to foreign tax which does not qualify for DT relief.

The ITA mixed fund regime gives no guidance because (1) and (2) both fall into the same mixed fund category. It is considered that the *Roxburghe* approach applies. A remittance from this mixed fund should be regarded as made first of all out of the income which qualifies for UK double tax relief. However, it would be better practice:

(1) to pay the income qualifying for DTT relief into a separate account, and
(2) to remit funds from that account.

Then this issue does not arise and a remittance from the DTT account can easily be identified as qualifying for DTT relief.

10.38 ITA mixed fund regime: commentary

The ITA mixed fund regime operates on a daily, indeed minute by minute basis, as the rules must be applied at the time of every onshore and offshore transfer. They do not operate within a given tax year on a pro rata basis (contrast the CGT or s.731 matching rules). The reader who has studied the text to here, and who contemplates applying these rules to the actual circumstances of clients, making hundreds or thousands of transfers, will agree that the mixed fund rule is unworkable.

Joint Forum on Expatriates Tax and NICs Note of Meeting 18 September 2008 records:

> Delegates asked whether HMRC would be prepared to allow for apportionment on an annualised (rather than a monthly) basis. The legislation concentrates on transfers from mixed funds on the occasion of each and every transfer. HMRC did not think it was possible to override the intention of the legislation but agents considered that it would be unworkable to examine each and every debit and credit on the

> basis envisaged within a new legislation....
> The overwhelming view put forward by external delegates was that without the availability of a methodology along the lines of SP 5/84 it would be impractical for any inward expatriate to claim access to the remittance basis because it would not be possible to perform the calculations required by the legislation.[97]

The mixed fund legislation is a disaster; it needs to be rethought from beginning to end – an immensely challenging task, which could not possibly have been done in the few days available as schedule 7 FA 2008 hurtled to the deadline for enactment. In their defence, HMRC make two points:

> [1] HMRC reminded delegates that use of the remittance basis is voluntary as from 6 April 2008 and [2] that HMRC had been asked to bring in rules on remittance from mixed funds and rules relating to overseas transfers.

But as to point [1], the fact that the remittance basis is voluntary is no excuse for bad tax law. HMRC have overlooked that the remittance basis is intended to make the UK an *attractive* place for foreign domiciliaries to reside.[98] There is no need to comment on point [2].

A few months later HMRC issued SP 1/09 so the step which was not thought possible apparently proved to be possible after all.[99] But while helping the employee who is resident and not ordinarily resident, that does not help the rest of the body of remittance basis taxpayers stuck with the same problems. Why were resident non-ordinarily resident employees be singled out for special treatment? The reason was presumably down to effective lobbying rather than any compelling policy consideration.

10.39 Remittance of nominated income or gains

10.39.1 *Outline*

EN FB 2008 provides:

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97 *www.hmrc.gov.uk/consultations/expat-mins-180908.htm*

98 An alternative analysis is that a decision was made deliberately to undermine the remittance basis by making it impracticably difficult to operate.

99 See 12.15 (Remittance from earnings for mixed UK/foreign earnings).

> 14... If, in subsequent years, that "nominated" income or gains upon which the RBC has been paid is, in fact, remitted to the UK, then that income or gains will not be taxed again. However, there are ordering rules to ensure that if "nominated" income or gains is, in fact, remitted when other untaxed income and gains remain unremitted, then that unremitted income and gains is treated as being remitted before the "nominated" income and gains.

The expression "nominated income and gains" is defined in s 809I(3). The drafter thought that this was a section-wide definition only, so he repeated the definition in s.809J(3). (If the definitions had been made ITA-wide definitions this repetition would not have been necessary). The definition provides:

> (3) In this section the individual's "nominated income and gains" are the total income and chargeable gains nominated by the individual under section 809C for the relevant tax year or any earlier tax year.

The definition is discussed in 9.13.2 (Nomination of income and gains)

10.39.2 *"Remittance basis income and gains"*

Section 809I(4) ITA gives this term a fairly commonsense meaning:

> An individual's "remittance basis income and gains" are the foreign income and gains of the individual for all the tax years (up to and including the tax year mentioned in subsection (1)(a)) for which section 809B, 809D or 809E applies to the individual, apart from the individual's nominated income and gains.

Nominated income/gains do not count as remittance basis income/gains because they are taxed on an arising basis. The drafter thought that this was a section-wide definition only, so he repeated the definition in s.809J(3). (If the definitions had been made ITA-wide definitions this repetition would not have been necessary):

> (4) In step (1) of subsection (1) the individual's "remittance basis income and gains" are the foreign income and gains of the individual for all the tax years (up to and including the relevant tax year) for which section 809B, 809D or 809E applies to the individual, apart from the

individual's nominated income and gains.

10.39.3 *Nominated income/gains categories*

The taxpayer must classify all his remittance basis income and gains into 8 categories, which I will call **"the nominated income/gains categories"**. The categories are set out in s.809J(2) ITA. These are almost the same as the nine mixed fund categories but:

(1) there are casual differences of wording which do not affect the meaning; and
(2) there are (incredibly) small differences of substance (I do not see why – if any reader can suggest a reason I would be interested to know).

I here set out a table which compares the two (the differences are italicised):

Nominated income/gains categories		**Mixed fund categories**	
		(a)	*employment income (other than income within para (b), (c) or (f))*
(a)	relevant foreign earnings (other than those subject to a foreign tax)	(b)	relevant foreign earnings (other than income within para (f))
(b)	foreign specific employment income (other than income subject to a foreign tax)	(c)	foreign specific employment income (other than income within para (f))
(c)	relevant foreign income (other than income subject to a foreign tax)	(d)	relevant foreign income (other than income within para (g))
(d)	foreign chargeable gains (other than gains subject to a foreign tax)	(e)	foreign chargeable gains (other than chargeable gains within para (h))
(e)	*relevant foreign earnings subject to a foreign tax*	(f)	employment income subject to a foreign tax,

(f)	*foreign specific employment income subject to a foreign tax*		
(g)	relevant foreign income subject to a foreign tax	(g)	relevant foreign income subject to a foreign tax
(h)	foreign chargeable gains subject to a foreign tax	(h)	foreign chargeable gains subject to a foreign tax
		(i)	income or capital not within another paragraph

Section 809I(6) ITA defines foreign tax for the purpose of the nominated income/gains categories:

> In subsection (2) "foreign tax" means any tax chargeable under the law of a territory outside the UK.

The same definition is used for the mixed funds categories and I discuss the definition there.[100]

10.39.4 *Condition for application of nominated income remittance rules*

Section 809I ITA provides:

> **809I Remittance basis charge: income and gains treated as remitted**
> (1) This section applies if—
> (a) any of an individual's nominated income and gains is remitted to the UK in a tax year, and
> (b) any of the individual's remittance basis income and gains has not been remitted to the UK in or before that year.
> (2) Income tax and capital gains tax are charged, for that year and subsequent tax years, as if
> [a] the income and chargeable gains treated under section 809J as remitted to the UK by the individual in that tax year had been so remitted
> [b] (and income and chargeable gains of the individual that were actually remitted in that year had not been).

100 See 10.28.3 (Ingredients of a mixed fund).

So we turn to s.809J ITA, which sets out artificial or fictional remittance rules which I call **“the nominated income remittance rules”.** (It would be more accurate to call this “the nominated income/*gains* remittance rules, but for convenience I shall where possible refer to income (rather than income/gains) and leave gains to be understood.)

Section 809J(1) provides:

> **809J Section 809I: order of remittances**
> (1) If section 809I applies, the following steps are to be taken for the purpose of determining the income or gains treated in a tax year (“the relevant tax year”) as remitted to the UK by the individual.

The section sets out six steps. It is easier to follow the steps if one has an example in mind.

Suppose T (a remittance basis taxpayer) has remittance basis income and gains of £10k per annum of each of the nominated income/gains categories thus:

Category	Type of income (in short)	Year 1	Year 2
(a)	relevant foreign earnings	£10k	£10k
(b)	foreign specific employment income	£10k	£10k
(c)	relevant foreign income	£10k	£10k
(d)	foreign chargeable gains	£10k	£10k
(e)	foreign taxed relevant foreign earnings	£10k	£10k
(f)	foreign taxed foreign specific employment income	£10k	£10k
(g)	foreign taxed RFI	£10k	£10k
(h)	foreign taxed gains	£10k	£10k

Suppose T has in addition to the above £30k nominated income and gains per annum.

T remits nothing in year 1. In year 2 T remits:

(a) £1k from his nominated income/gains.

(b) £80k from his remittance basis income/gains.

This brings the nominated income remittance rules into action. (Even if only 1p of the nominated income/gains had been remitted, that would suffice. There is no de minimis rule.[101])

> *Step 1*
> *Find the total amount of—*
> *(a) the individual's nominated income and gains, and*
> *(b) the individual's remittance basis income and gains,*
> *that have been remitted to the UK in the relevant tax year.*
> *This amount is "the relevant amount".*

In the example the relevant tax year is year 2. Applying the facts of the

101 HMRC say they will take this point. March 2009 Qs & As provides:

"**Q13:** Cross-collateralisation of debts. Many banks are currently setting up dedicated accounts (with capital of say £100) which will earn just sufficient income (say £1) to be used as nominated income for the purposes of the £30,000 charge. However, under their standard terms and conditions, the bank will often have a floating charge over every account the individual has with them as support for any lending. If any of that lending is brought into the UK then there is a concern that the £1 income in the nominated account might be said to be 'used outside the UK in respect of a relevant debt' because it is, theoretically at least, capable of being taken in support of the borrowing under the cross-collateralisation. In practice, of course, the £1 in the nominated income account makes no difference one way or the other to the bank's security. One answer to this, of course, is for the banks to change their standard terms and conditions to exclude the nominated account. However, this is easier said than done and is unlikely in most cases to be done before 6 April 2009. The concern, as you will realise, is that if any nominated income is - as a result of this - deemed to be remitted then this results in re-characterisation under s809I and s809J, spoiling careful account segregation for ever afterwards.

Is there any possibility that we could have some de minimis here so that, say, up to £100 of nominated income would not be treated as remitted in these circumstances?

A: No. Whether or not this is an issue will depend on the terms and conditions attached to the accounts and loans held with the bank or other financial institution. If individuals are concerned about this issue then it would make sense to simply open a separate account with a different financial institution."

example, the relevant amount is £81k.

> *Step 2*
> *Find the amount of foreign income and gains of the individual for the relevant tax year (other than income or chargeable gains nominated under section 809C) that is within each of the categories of income and gains in paras (a) to (h) of subsection (2).*
> *If none of sections 809B, 809D and 809E apply to the individual for that year, treat those amounts as nil (and accordingly go to step 6).*

"The amount of foreign income and gains of the individual for the relevant tax year (other than income or chargeable gains nominated under section 809C)" means the remittance basis income/gains. (It appears that the drafter has forgotten to use the term which he has defined (twice) for this purpose; but it does not matter.) The amount in the example is as set out in the table above.

> *Step 3*
> *Find the earliest paragraph for which the amount determined under step 2 is not nil.*

The earliest paragraph is para (a).

> *If that amount does not exceed the relevant amount, treat the individual as having remitted the income or gains within that paragraph (and for that tax year).*

The individual is treated as having remitted £10k relevant foreign earning, category (a) for year 2.

> Otherwise, treat the individual as having remitted the relevant proportion of each kind of income or gains within that paragraph (and for that tax year).
> "The relevant proportion" is the relevant amount divided by the amount determined under step 2 for that paragraph.

(Had the total remittance been (say) £5k then the relevant proportion would have been £5k÷£10k = 50% so the transfer would have been treated as containing £5k employment income category (a) for year (1).)

> *Step 4*
> Reduce the relevant amount by the amount taken into account under step 3.

The relevant amount is reduced to £71k

> *Step 5*
> If the relevant amount (as reduced under step 4) is not nil, start again at step 3.
> In step 3, read the reference to the earliest paragraph of the kind mentioned there as a reference to the earliest such paragraph which has not previously been taken into account under that step.

Following this iterative procedure a total of eight times, the transfer is treated as containing:

(a) relevant foreign earnings	£10k
(b) foreign specific employment income	£10k
(c) relevant foreign income	£10k
(d) foreign chargeable gains	£10k
(e) foreign taxed RFE	£10k
(f) foreign taxed SEI	£10k
(g) foreign taxed RFI	£10k
(h) foreign taxed gains	£10k
Total	**£80k**

The relevant amount is by this stage reduced to £1k. We move to the next step:

> *Step 6*
> *If the relevant amount (as reduced) is not nil once steps 3 to 5 have been undertaken in relation to all paragraphs of subsection (2) for which the amount determined under step 2 is not nil, start again at step 2.*
> *In step 2, read the reference to the foreign income and gains of the individual for the relevant tax year as a reference to such of the foreign income and gains of the individual for the appropriate tax year as had*

> *not been remitted*[102] *by the beginning of the relevant tax year.*
> *"The appropriate tax year" is the latest tax year which is—*
> *(a) before the last tax year for which step 2 has been undertaken, and*
> *(b) a tax year for which section 809B, 809D or 809E applies to the individual.*

Thus we repeat step 2 a last and ninth time, reading "the relevant tax year" to mean year 1. So the remittance of £81k is treated as being:

(a) relevant foreign earnings	£11k
(b) foreign specific employment income	£10k
(c) relevant foreign income	£10k
(d) foreign chargeable gains	£10k
(e) foreign taxed RFE	£10k
(f) foreign taxed SEI	£10k
(g) foreign taxed RFI	£10k
(h) foreign taxed gains	£10k
Total	**£81k**

March 2009 Qs & As provides:

> **Q3:** HM Revenue & Customs (HMRC) have indicated that individuals do not have to specify which account the nominated income comes from, and from this it could be inferred that without further disclosure of the particulars of the account the taxpayer may be at risk of "tainting" every other source of income of that type. For example if an individual has an account with one bank in Jersey and another bank in a different jurisdiction, he could nominate bank interest on his Jersey account, so that it would be obvious that if he remitted income from his other account, he might not fall foul of re-characterisation provisions. However, this may not be the case if he had three different accounts with the same bank in Jersey and he wishes to nominate income from one of those accounts without disclosing the account number of that

102 Section 809I(5) ITA provides:
In step 6 of subsection (1) the reference to income or gains being remitted is—
(a) as respects any tax year before section 809I applies, to income or gains being remitted to the UK, and
(b) as respects any tax year in relation to which that section applies, to income or gains treated under this section as so remitted.

> account. Can HMRC clarify what their approach to this will be?
> **A:** It is up to the individual to decide how much information to give HMRC on their Self Assessment returns in order to identify the source of the nominated income or gains; if, as in this example, there is more than one account the individual should provide sufficient detail to distinguish between them and identify the "nominated" account. That might be the entire account number, or the account "name", or some other unique identifying feature of the account.

March 2009 Qs & As makes an obvious point:

> **Q6:** If I use nominated income or gains to pay the remittance basis charge of £30,000 it would appear that does not trigger the provisions in sections 809I and 809J. Is that right?
> **A:** If £30,000 of the nominated income or gains is brought to the UK to pay the remittance basis charge, it is treated as not remitted to the UK under section 809V. Therefore section 809I does not apply because none of the individual's nominated income or gains is regarded as having been remitted to the UK in that tax year. If the £30,000 is repaid by HMRC then it is treated as remitted at that point and so section 809I will be triggered.

10.39.5 *Accidental remittance of nominated income/gains*

The RDR Manual provides:

> If an individual accidentally remits any nominated income or gains to the UK then HMRC will allow them to undo their mistake, by reversing the transfer without unreasonable delay and in any event before the end of the tax year, for example by paying the income or gains back to the original account, so that the ordering rules at s809I and s809J will not apply.
> HMRC will only use its discretion in such situations as long as there have been no relevant transactions or other benefits conferred on a relevant person in the interim. Otherwise the s809J ordering rules will apply.
> For example, if £20,000 is transferred in error from an overseas bank to a UK bank account and two weeks later the account owner realises the mistake and immediately transfers that £20,000 directly back to the overseas bank account, HMRC will accept that s809I and s809J do not apply. However if, for example, the £20,000 was spent in the UK and

then £20,000 from another UK account was transferred back to the overseas account then s809I and s809J do apply.

10.39.6 *Remittance basis charge and section ITA07/s809V*

The RDR Manual provides:

If taxpayers use nominated income or gains to pay the remittance basis charge of £30,000 it is treated as not remitted to the UK under ITA07/s809V (see Chapter 4: Remittance basis charge – money paid directly to HMRC). Therefore the "ordering rules" at ITA07/s809I and s809J do not apply because none of the individual's nominated income or gains is regarded as having been remitted to the UK in that tax year. lf the £30,000 is repaid by HMRC then it is treated as remitted at that point and so s809I is triggered.

10.39.7 *HMRC example*

The RDR Manual provides:

Remittances of nominated income or gains - examples

Example 1

A has foreign income or gains, and uses the remittance basis as follows:

	Foreign chargeable gains Paragraph (d)	Relevant foreign income – Jersey Paragraph (c)	Relevant foreign earnings Paragraph (a)	Nomination (from Jersey RFI)
2010-11	£250,000	£75,000	£200,000	£75,000 RFI
2011-12	£300,000	£80,000	£120,000	£75,000 RFI
2012-13	Nil	£75,000	£280,000	£75,000 RFI
2013-14	£130,000	£80,000	£150,000	£75,000 RFI
Totals	**£680,000**	**£310,000**	**£750,000**	

In 2013-14 A actually and identifiably remits:

£30,000 Jersey relevant foreign income that she nominated in 2010-11,
£140,000 foreign chargeable gains from 2011-12 and
£50,000 relevant foreign earnings from 2013-14.

The ordering rules are triggered. The “relevant year” is 2013-14.

Step 1 – Identify nominated income and gains remitted in the relevant year	£30,000	**Relevant Amount**	£220,000
Identify the remittance basis income and gains remitted in the relevant year	£190,000		
Step 2 Find the total amount of the individual’s **foreign income and gains (excluding those nominated)** for the relevant tax year	**Para (a)** Relevant foreign earnings (not subject to a foreign tax) **Para (c)** Relevant foreign income (not subject to a foreign tax) **Para (d)** Foreign chargeable gains (not subject to a foreign tax)		£150,000 £5,000 £130,000
Step 3 Identify the earliest of paragraphs (a) to (h) above for which the amount determined in Step 2 is not nil.	**Para (a)**		£150,000
Step 4 - Where the relevant amount is greater than the amount identified above the relevant amount is reduced by the amount identified			£220k *less* £150k = £70,000
Step 5 - If the relevant amount is not nil go back and repeat Step 3. Take the reference to the first of paragraphs (a) to (h) as a reference to the earliest paragraph not previously taken into account under Step 3.			
Step 3 - repeated	**Para (c)**		£5,000
Step 4 - repeated.		Relevant Amount reduced to:	£65,000
Step 5 - In the order of preference listed above repeat Steps 3 and 4.			
Step 3 - repeated	**Para (d)**		£130,000
Step 4 If the relevant amount is less than the amount identified, treat the whole of the remaining amount of the transfer as coming from that item of income or gain.			

So A will be taxed on £220,000 of remittances as if she had actually remitted the following:

		2010-11	**2011-12**	**2012-13**	**2013-14**
Foreign chargeable gains	Accruing in year	£250,000	£300,000	Nil	£130,000
	Actually remitted	£Nil	£140,000	£Nil	£Nil
	Treated as remitted	£Nil	£Nil	£Nil	**£65,000**
Relevant foreign income Nominated	Arising in year	£75,000	£75,000	£75,000	£75,000
	Actually remitted	£30,000	£Nil	£Nil	£Nil
	Treated as remitted	£Nil	£Nil	£Nil	£Nil
Relevant foreign income Not nominated	Arising in year	£Nil	£5,000	£Nil	£5,000
	Actually remitted	£Nil	£Nil	£Nil	£Nil
	Treated as remitted	£Nil	£Nil	£Nil	**£5,000**
Relevant foreign earnings	Accruing in year	£200,000	£120,000	£280,000	£150,000
	Actually remitted	£Nil	£Nil	£Nil	£50,000
	Treated as remitted	£Nil	£Nil	£Nil	**£150,000**

If in future years she actually remits any of these monies, the ordering rules will treat her as having remitted something else instead (see continuation example 1a).

Example 1a - Continued

Following on from the example 1, in 2014-15 A has relevant foreign earnings of £80,000, but no other foreign income or gains. She decides not to use the remittance basis in that year.

In 2014-15 A actually brings into the UK;

£5,000 Jersey relevant foreign income that she did not nominate in 2013-14 (note 1)

£80,000 relevant foreign earnings from 2013-14 and

£80,000 relevant foreign earnings from 2014-15

Although A is not using the remittance basis in 2014-15, the ordering rules at ITA07/s809J are still required to determine what she is to be taxed as having remitted in that year. The relevant year is 2014-15.

<table>
<tr><td>Step 1 – Identify nominated income and gains remitted in the relevant year (2014-15)</td><td>£nil</td><td rowspan="2">Relevant Amount</td><td>£85,000</td></tr>
<tr><td>Identify the remittance basis income and gains remitted in the relevant year</td><td>£85,000
(See note 2)</td><td></td></tr>
<tr><td colspan="3">Step 2
Find the total amount of the individual’s foreign income and gains (excluding those nominated) for the relevant tax year If the remittance basis was not used in that year (that is sections 809B, s809D or s809E did not apply), treat those amounts as nil and go to step 6</td><td>Nil</td></tr>
<tr><td colspan="4">Step 6
If the relevant amount is not nil, start again at step 2. Take the reference to “relevant year” to be a reference to foreign income of gains of the individual for the earliest ‘appropriate year’ previous to the lat tax year from which Step 2 was undertaken.</td></tr>
<tr><td>Step 2 - Find the total amount of the individual’s foreign income and gains (excluding those nominated) for the appropriate tax year (2013-14) (see note 3)</td><td colspan="2">Para (d) Foreign chargeable gains (not subject to a foreign tax)</td><td>£65,000</td></tr>
<tr><td colspan="2">Step 3 Identify the earliest of paragraphs (a) to (h) above for which the amount determined in Step 2 is not nil.</td><td>Para (d)</td><td>£65,000</td></tr>
<tr><td colspan="2">Step 4 - Where the relevant amount is greater than the amount identified above the relevant amount is reduced by the amount identified</td><td>Relevant Amount reduced to:</td><td>£85k less £65k
= £20,000</td></tr>
<tr><td colspan="4">Step 5 - If the relevant amount is not nil go back and repeat Step 3. Take the reference to the first of paragraphs (a) to (h) as a reference to the earliest paragraph not previously taken into account under Step 3.</td></tr>
<tr><td colspan="4">Step 6
If the relevant amount is not nil after Steps 3-5 have been completed for the year, start again at step 2. Take the reference to ‘relevant year’ to be a reference to foreign income of gains of the individual for the earliest ‘appropriate year’ previous to the lat tax year from which Step 2 was undertaken.</td></tr>
</table>

Step 2 - Find the total amount of the individual's foreign income and gains (excluding those nominated) for the appropriate tax year (2012-13)	**Para (a**) Relevant foreign earnings (not subject to a foreign tax)	£280,000
Step 3 Identify the earliest of paragraphs to (h) above for which the amount determined in Step 2 is not nil	**Para (a)**	£280,000
Step 4 If the relevant amount is less than the amount identified, treat the whole of the remaining amount of the transfer as coming from that item of income or gain		

So in 2014-15 A is treated as having remitted
£20,000 relevant foreign earnings
£65,000 foreign chargeable gains.
NB – The £80,000 relevant foreign earnings from 2014-15 that she brings in will be taxed on the arising basis in that year.

Note 1 – In 2013-14 A has £80,000 of Jersey relevant foreign income, of which £75,000 were nominated; if this £80,000 were all in the one single account, and there was nothing else in the account then, under the principle of this section the first £5,000 remitted in 2014-15 is accepted as being "not-nominated" income.

In this example it is of little practical difference because the s809J ordering rules have already been "triggered" in 2013-14 by her remittance of nominated income (from 2010-11).

But if the ordering rules had not already been triggered, then because, this £5,000 Jersey relevant foreign income in 2014-15 can be accepted as being "unnominated" income first and foremost, so A's remittance of this £5,000 would not, of itself, have triggered the s809J ordering rules in this year.

Note 2 – A's remittance basis income and gains are her total foreign income or chargeable gains for all tax years up to the "relevant tax year (2014-15) in which she used the remittance basis under section 809B, section 809D or section 809E. It therefore excludes her relevant foreign earnings from 2014-15 because she is not using the remittance basis in that year.

Note 3 – the "foreign income and gains 'for' the appropriate year exclude any:

- "nominated" income or gains, or
- income or gains that were actually remitted to the UK before the beginning of the appropriate tax year or
- income or gains that were treated as remitted to the UK previously under section 809J before the beginning of the appropriate tax year.

In A's case, the £5,000 Jersey relevant foreign income from 2013-14, and the £80,000 relevant foreign earnings from 2013-14 that she actually remitted in 2014-15 were treated as having been remitted in 2013-14 by the ordering rules (see example 1).

A: Summary Table – following both years:

		2010-11	2011-12	2012-13	2013-14	2014-15
Foreign chargeable gains	Accruing in year	£250,000	£300,000	£Nil	£130,000	£Nil
	Actually brought to UK	£Nil	£140,000	£Nil	£Nil	£Nil
	Treated as remitted	£Nil	£Nil	£Nil	**£130,000**	£Nil
Relevant foreign income Nominated	Arising in year	£75,000	£75,000	£75,000	£75,000	£Nil
	Actually brought to UK	£30,000	£Nil	£Nil	£Nil	£Nil
	Treated as remitted	£Nil	£Nil	£Nil	£Nil	£Nil
Relevant foreign income Not nominated	Arising in year	£Nil	£5,000	£Nil	£5,000	£Nil
	Actually brought to UK	£Nil	£Nil	£Nil	£5,000	£Nil
	Treated as remitted	£Nil	£Nil	£Nil	**£5,000**	£Nil
Relevant foreign earnings	Arising in year	£200,000	£120,000	£280,000	£150,000	£80,000
	Actually brought to UK	£Nil	£Nil	£Nil	£130,000	£80,000
	Treated as remitted	£Nil	£Nil	**£20,000**	**£150,000**	£Nil

10.40 Nominated income: commentary

In short, the effect of the nominated income remittance rule is that remittances are treated as being made in the nominated income/gains priority order, taking more recent years before earlier years (regardless of the actual remittances). As in the case of the "steps" of the mixed fund rules, one is tempted to ask: why didn't the statute simply say so?

But the drafting is the least of the problems of the nominated income remittance rule. The author of the EN anticipates criticism that this is administratively difficult and offers some tax planning advice:

> 14...The rules dealing with this in sections 809I and 809J will require additional records to be maintained from 6 April 2008 or the first year of residence in the UK, if later.
> 15. The record keeping necessary for sections 809I and 809J can be avoided if individuals ensure that "nominated" income or gains upon which the RBC is paid are not remitted to the UK, or only remitted after the remittance of all other unremitted income and gains since the first year of residence from April 2008. If an individual is confident they will never need to remit that "nominated" income or gains, paying the RBC will not involve any extra complexity or record keeping.[103]

Even if this advice were correct it would not help the majority of remittance basis taxpayers, but they should not complain about administrative complexity: they are responsible for the problem, which they brought on themselves by making a claim for the remittance basis:

> 16. As mentioned earlier, those eligible can choose whether or not to claim the remittance basis for each particular year, depending on whether it is to their advantage to do so.

But even the administrative inconvenience is not the serious problem of the rule. The effect of the rule is that if the individual remits a penny of his nominated income/gains, one disregards entirely the actual remittances and charges on the basis of the fictional rules. Thus an individual who actually remits gains is taxed as if he remitted income (as long as he also remits a penny of nominated income.) It is therefore in principle desirable to take care not to remit any nominated income/gains.

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103 The last sentence is not correct. It is not enough that an individual is "confident that they will never need to remit that nominated income or gains". The individual must be able to demonstrate to HMRC that he has not remitted, and that requires record keeping.

10.41 Remittance before income or gains arise

Section 809U ITA provides:

> **809U Deemed income or gains not to be regarded as remitted before time when they are treated as arising or accruing**
> Where—
> (a) income or foreign chargeable gains are treated as arising or accruing, and
> (b) by virtue of anything done in relation to anything regarded as deriving from the income or chargeable gains, the income or chargeable gains would otherwise be regarded as remitted to the UK before the time when they are treated as arising or accruing,
> treat the income or chargeable gains as remitted to the UK at that time.

EN Remittance Basis Amendments 482 to 493 states:

> Under the original wording such payments might in certain circumstances become chargeable before the tax year in which the income or gain is treated as arising. The amendment ensures that cannot happen.

This can apply where s.87 TCGA applies and under the accrued income scheme.[104]

10.42 Relief for payment of remittance basis charge

Section 809V ITA provides:

> (1) Money that is brought to the UK by way of one or more direct payments to the Commissioners [HMRC] is to be treated as not remitted to the UK—
> (a) if the payments are made in relation to a tax year to which section 809H applies, and
> (b) if, or to the extent that, the payments do not exceed £30,000.
> (2) Subsection (1) does not apply to a payment if, or to the extent that, it is repaid by the Commissioners.

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104 See 38.14 (Section 87 remittance basis).

The RDR Manual provides:

Remittance basis charge – money paid directly to HMRC
Money brought into the UK to pay the remittance basis charge (RBC) is to be treated as not remitted to the UK if direct payment is made to HMRC (ITA07/s809V(1)).
This will only apply if the money is paid:

- in respect of the tax due for the year in which the remittance basis has been claimed, **and**
- the remittance basis charge is due for that tax year..

It is only remittances that relate to the remittance basis charge that are covered. Remittances of foreign income or gains to pay any other liability to UK tax, including for example income tax or capital gains tax on remitted amounts, are themselves chargeable to UK tax as remitted income or gains of the tax year in which the tax is paid to HMRC (although see also remittances of nominated income).
The remittance basis charge can be paid in one or more amounts. However, the amount that benefits from the exemption provided at s809V is limited to the amount of the charge, that is £30,000. The £30,000 can be paid in one lump sum or in several stages, and may form part of the payments on account paid on the 31 January or 31 July, or may be paid as a balancing payment. The exemption applies as long as the payment is in relation to the tax year in which the remittance basis charge is due.
The exemption only applies where the remittance basis charge is paid **directly** from foreign income or gains held outside the UK, the payment must be made direct to HMRC. This can be done either by:

- cheque (drawn on a foreign bank account)
- electronic transfer of funds.

Taxpayers will need to keep sufficient records to show that payment of the £30,000 RBC was made directly to HMRC from an overseas account. A copy of a cheque (or cheques) drawn on the foreign bank account, or the relevant bank statement identifying the bank transfer are examples of acceptable evidence.
If the £30,000 remittance basis charge is paid from a UK bank account, including a transfer from a foreign account to the individual's UK bank account before being paid to HMRC, the payment will fall outside the exemption. To the extent that the amount of money is foreign income or gains of the taxpayer, the transfer from the foreign bank to the individual's UK bank account is a taxable remittance.
See also Chapter 3: Meaning of remittances and Chapter 5: Quantifying amounts remitted.
Example 1
A is a long-term UK resident remittance basis user. He uses the remittance basis in 2008-09 and plans to use it in 2009-10 also. A therefore makes payments on account of £100,000 on 31 January 2009 and on 31 July 2009 in respect of his 200910 liability.
In July 2009 he pays £40,000 of that payment on account from his 2008-09 foreign income. Payment is made by cheque drawn on an account at a bank in the

Isle of Man that was sent direct to HMRC.
A's tax liability for 2009-10 is £200,000 including the remittance basis charge of £30,000, which has been wholly met from the payments on account that he has made. No further tax is due for this year.
Because £40,000 of the tax that A has paid on account was paid directly to HMRC from an overseas account, £30,000 of the £40,000 income remitted may be treated as not remitted to the UK and is not chargeable to tax, unless A has instructed otherwise. The remaining £10,000 will be taxed as a remittance in the normal way. As it was remitted in July 2009 it will be a taxable remittance for the tax year 200910, and should be declared as such.
In this example, all of the £40,000 was remitted in July. However the remittances might be split between the payment on account dates, for example £20,000 remitted on 31 January 2009 and a further £20,000 on 31 July 2009. In such cases, unless the taxpayer specifies otherwise, the £10,000 that is not subject to the exemption and so is a taxable remittance will be treated as having occurred at the later date, as this will usually be in the taxpayer's favour. See page below for example of where the "remittance basis charge" is repaid to A, or otherwise no longer applies.
Note – taxpayers may choose to specify that a payment made is in respect of the remittance basis charge at time of payment. However they are not obliged to do so and it is not necessary as long as payments received can be clearly related to a tax year for which the remittance basis charge is due.

Nominated Income or gains

If taxpayers use nominated income or gains to pay the remittance basis charge of £30,000 it is treated as not remitted to the UK under section 809V. Therefore you do not have to apply the "ordering rules" at ITAs809I and s809J, because none of the individual's nominated income or gains is treated as having been remitted to the UK in that tax year. See Chapter 5: Remittances of nominated income or gains.
If the £30,000 is repaid by HMRC then it is treated as remitted at that point (see next page) and so section 809I will be triggered.

Remittance basis charge – repayment by HMRC

There may be some exceptional circumstances where the £30,000 remittance basis charge is paid to HMRC but then is later repaid, or is otherwise no longer due.
Any foreign income or gains remitted to pay the charge and initially covered by the exemption at ITA07/s809V will be regarded as a remittance when the charge is withdrawn and/or the repayment is made and so will be treated as liable to UK tax at that point (ITA07/s809V(2)).

Change of claim

The £30,000 remittance basis charge is most likely to be repaid where an individual, having made a claim for the remittance basis and paid the charge for that year, subsequently decides not to claim the remittance basis for that year and makes an amendment to their Self Assessment return (TMA1970/s9ZA). In such circumstances ITA07/s809H will not apply for that tax year, so the exemption cannot apply either.

Change of status

The other situation where the £30,000 is likely to be repaid or not otherwise due is where it later transpires that an individual has claimed the remittance basis for a tax year but was not entitled to do so as they were UK domiciled and UK ordinarily resident in that year.

Effect

If the exemption under section 809V was claimed then the foreign income or gains used to pay the remittance basis charge will not have been subject to tax in the year in which they arose/accrued because the individual used the remittance basis in that year. Due to the exemption the income or gains will also not have been subject to tax when brought into the UK. In such situations there are two possibilities:

- the £30,000 payment was made from foreign income or gains from an earlier year in which the individual **was** entitled to claim the remittance basis and did so. The £30,000 is treated as a taxable remittance and will be taxable in the in which the remittance occurred.
- the £30,000 payment was made from foreign income or gains from the present year or an earlier year in which the individual **was not** entitled to claim the remittance basis. In which case the income or gains will be taxed on the arising basis for the year in which the foreign income or gains actually arose. If the return cannot be amended you may need to deal with such assessments under the "discovery provisions" at TMA70/s29.

Example 1

In the earlier example above, A's circumstances change and he decides not to claim to be taxed on the remittance basis for 2009-10. His liability for 2009-10 is £195,000.

When A made the payment on account of £40,000 in July 2009 he anticipated that £30,000 of it would be attributed to the remittance basis charge. In the event he did not claim to be taxed on the remittance basis. He does not have to pay the remittance basis charge.

None of the payments on account can therefore be attributed to the remittance basis charge and the £40,000 that A paid from his 2008-09 foreign income (remember that A did use the remittance basis in 2008-09) in July 2009 is a taxable remittance. Any cases of difficulty should be referred to CAR: Offshore Personal Tax Remittance Basis Technical Team.[105]

10.43 Foreign services relief

Section 809W ITA provides a relief which I call "**foreign services relief**". Section 809W(1) provides:

> This section applies to income or chargeable gains if—
>
> (a) the income or gains would (but for subsection (2)) be regarded as remitted to the UK because conditions A and B in section

105 See too December 2008 Qs & As Q34, 35.

809L are met,

(b) condition A in section 809L [remittance condition A] is met because a service is provided in the UK ("the relevant UK service"), and

(c) condition B in section 809L [remittance condition B] is met because section 809L(3)(a) or (b) applies to the consideration for the relevant UK service ("the relevant consideration").

Section 809W(2) ITA provides the relief:

> The income or chargeable gains are to be treated as not remitted to the UK if the following conditions are met but this is subject to subsection (5).

I refer below to "**services relief conditions A and B**" to distinguish them from the myriad other conditions in the ITA.

EN Clause 23 Sch 7 Remittance Basis Amendment 354 provides:

> 12. Following publication of the Finance Bill consultation with representative bodies and other interested parties revealed that the original changes could have a detrimental effect on some UK service providers.

Five minutes thought would have been sufficient to reveal that fact; but there it is. The EN continues:

> ... The amendment addresses those concerns by providing an exemption in certain circumstances.

There is no relief in relation to remittance conditions C or D.

10.43.1 *Services relief condition A*

Section 809W(3) ITA provides:

> Condition A is that the relevant UK service relates wholly or mainly to property situated outside the UK.

EN Clause 23 Sch 7 Remittance Basis Amendment 354 provides:

> 7. Condition A would cover for example, fees paid to a UK bank for managing an individual's overseas investment portfolio. It would cover legal or brokerage fees in respect of offshore assets, such as the legal fees on the sale of a foreign house.

One needs to determine the property to which the service relate and its situs.

Situs is straightforward. Section 809W(6) incorporates the CGT situs rules:

> Sections 275 to 275C of TCGA 1992 (location of assets) apply for the purposes of subsection (3) as they apply for the purposes of TCGA 1992.

The EN continues:

> 13. Among the sort of payments that Condition A might cover would be fees paid by non-UK resident trustees to UK advisers for advice on
> [1] managing the assets held in the trust or
> [2] non-UK assets the trustees are considering purchasing.

That is obvious. More importantly, the relief applies to such fees paid by UK resident individuals. The EN continues:

> Accountancy fees for preparing non-UK tax returns would also be covered providing the majority of the accountancy services relates to non UK property.

More importantly, fees for preparing UK tax returns will similarly be covered. Relief will apply to investment management advice if the investment portfolio was mainly non-UK situate.

The examples raise, but do not address, the important and imponderable question of where services of this kind are provided. (Unless the services are provided in the UK there is no need for foreign property services relief.)

Questions 20-23 January 2009 Qs &As provide:

> **Q20:** If the work is undertaken for a foreign trust or company, is it relevant whether or not it holds UK property?
> **A:** In all these questions the provisions in section 809W depend on sections 809L and 809M being met; i.e. the individual's foreign income

and gains must be used to pay for this service, and the company must be a relevant person. The remaining answers are based on that assumption: Published January 2009 8

Q21: A Jersey company owns a portfolio of UK real estate; and a UK-based advisor produces a tax report in respect of the company's UK activities. Is this work in respect of a foreign asset, i.e. the Jersey company, or UK assets, i.e. the real estate?

A: The relevant UK service is the provision of advice in a tax report to a relevant person, which relates to the Jersey company's UK activities. It is the UK activities which are the subject of the advice.

Q22: What would happen if the Jersey company in the example above had a second French property business and the UK-based advisors produced a report in respect of the French business; would it matter that the majority of the value of the company's shares was attributable to its UK business?

A: No. The service provided to the relevant person – in this case the preparation of the report – relates to a non-UK property. So section 809W would apply, assuming the other conditions are also met.

Q23: We produce a US tax return for a UK resident non-domicile; please comment on the following and say whether relief is possible:

(i) his major source of income is UK salary,

(ii) most of the work undertaken is in respect of his UK sources of income and gains, albeit these are small compared to his world wide income and gains.

A: Advice on the completion of a non-UK tax return would be within the exemption providing the majority of the advice relates to non-UK property. To expand on this a little:

(i) advice relating to non-asset related income, e.g. employment income, whether UK or not – as there is no property, section 809W cannot apply;

(ii) advice relating to investment income/gains from UK sources is outside the exemption if the work is related mostly to this;

(iii) advice relating to investment income/gains from non-UK sources – within the exemption if the work is related wholly or mainly to this.

10.43.2 *"Wholly or mainly"*

EN Clause 23 Sch 7 Remittance Basis Amendment 354 provides:

14. Condition A would not cover payments for services in respect of property wholly in the UK or where the service was provided in respect

> of a mixture of UK and non-UK property and the majority of the property was in the UK. For example, legal fees on the sale of a UK house would not be covered.
> 15. The phrase “wholly or mainly” in Condition A means in this context that if a payment to a UK adviser relates to advice given on both UK and overseas property, that payment will not be treated as a remittance so long as more than half the advice relates to the overseas property.

The RDR Manual provides:

> For the purposes of applying the exemption “wholly or mainly” means more than half. Wholly or mainly relates to the service provided, not the property, and is, in general, judged by reference to work done, normally time spent.
> However, if advisers value the measurement of work done using a variety of factors, such as, for example a basis of both time and fee rate (e.g. use of a team specialising in international property), it is appropriate that this should be reflected in the considerations of “wholly or mainly”. Other factors may include the fee and time rate if specialist advice was required, split of assets between UK and foreign situs, and the place of research or administration.

March 2009 Qs As provides:

> **Q25:** In circumstances where an investment adviser gives advice to a relevant person regarding their investments over the course of the year, how should we apply the “wholly or mainly” test in section 809W(3) to determine whether payment for the service would constitute a remittance? This is particularly unclear where a service is provided which relates to property situated both within and outside the UK.
> **A:** If the service can be clearly identified, by the relevant fees structure, invoicing arrangements and similar information, as being directly related to assets situated in the UK then, it will not be regarded as having met condition A in section 809W(3). If, on the other hand, the service cannot be clearly identified in this way, then it will be necessary to consider other means to decide whether section 809W(3) applies; for instance, if the provider of the services charges fees for the work undertaken on the basis of both time and fee rate, it might be appropriate to use this as a way of determining the extent to which the service relates to property situated in the UK or to property outside the UK.

10.43.3 *Services relief condition B*

Section 809W(4) sets out services relief condition B:

> Condition B is that the whole of the relevant consideration is given by way of one or more payments to one or more bank accounts held outside the UK by or on behalf of the person who provides the relevant UK service.

I am unable to see the purpose of services relief condition B. It is a hangover from the rule in *Timpson's Executors v Yerbury* applicable under the pre-2008 remittance basis. Perhaps the policy was that nothing which was a remittance under the pre-2008 rules should cease to be a remittance under the ITA remittance rules. If so the policy was wholly misguided. The opportunity should have been taken to create an entirely new and coherent set of rules. As it is, suppliers of services relating to foreign property will need to open foreign bank accounts and ensure that the client pays his fees into that account; a pointless bureaucratic requirement, but there it is.

In practice no doubt the service provider will generally remit the payment to the UK immediately on receipt. That cannot affect the customer's tax position. The customer will not know, and will not be entitled to know, what the supplier does with its own money.

10.43.4 *Exceptions*

Section 809W(5) ITA provides:

> Subsection (2) does not apply if the relevant UK service relates (to any extent) to the provision in the UK of—
> (a) a benefit that is treated as deriving from the income by virtue of section 735, or
> (b) a relevant benefit within the meaning of section 87B of TCGA 1992 that is treated as deriving from the chargeable gains by virtue of that section.

I cannot see what the legislation is aiming at here. The following conditions must all be satisfied:

(1) A service is provided in the UK.

(2) The service relates to non-UK property.
(3) The service relates to the provision in the UK of a benefit within s.731 or a capital payment for CGT.

Points (2) and (3) appear to be contradictory, but even if one could weave a course which satisfies both, why withhold foreign services relief? I would be grateful to any reader who could explain.

10.43.5 *Planning: split invoicing*

The RDR Manual provides:

> If the services (and thus the consideration due for that service) can be clearly and specifically identified as relating either to UK assets or to non-UK assets and it is possible to separately identify this from the fees structure and invoicing, the work relating to UK assets will not be regarded as meeting the "wholly or mainly" test at Condition A in section 809W. This does not necessarily require a separate advice letter, report or invoice ("split-invoice") to be issued, as long as the individual is clearly able to identify from the invoice to what his payments relate.
> If there is a split contract for services relating to UK and non-UK assets you should accept the computations if the split bears a reasonable resemblance to the actuality of service provided.
> Any attempt to use artificial or otherwise unrealistic cost structures, for example to increase the costs attributed to non-UK property advice work against UK-property advice work should be strongly resisted.

10.44 Exempt property

Section 809X ITA provides:

> (1) Exempt property which is brought to, or received or used in, the UK in circumstances in which section 809L(2)(a) applies is to be treated as not remitted to the UK.

There are five categories of exempt property. These relate to:

(1) public access,
(2) personal use,
(3) a *de minimis* exemption,

(4) temporary importation,
(5) the repair rule.

In the FA 2008, exemptions (2) to (5) were limited to relevant foreign income. This was absurd, though it was a conscious decision.[106] HMRC belatedly agreed. The FA 2009 extended the exemptions to apply to all types of income, with retrospective effect.

10.44.1 *"Property"*

Section 809Z6 ITA provides some definitions. Section 809Z6(1) ITA provides:

> This section applies for the purposes of sections 809X to 809Z5.

These definitions are expressed to apply only for the purposes of s.809X to 809Z5, but they are also needed in s.809Z6 so they have to be repeated there.

Section 809Z6(2) ITA provides:

> "Property" does not include money.

Elsewhere in the provisions the word "property" does include money. This breaches the somewhat elementary principle of good drafting, that the same word should not be used with different meanings, but there it is. I shall refer where appropriate to "property (excluding money)".

10.44.2 *"Money"*

Section 809Z6(3) ITA defines money:

> In subsection (2) "money" includes—
> (a) a traveller's cheque,
> (b) a promissory note,

106 EN FB 2008 provided:
"31. The current rules for employment income and capital gains already tax assets brought into the UK where they were purchased out of untaxed foreign employment income or capital gains. Those rules remain unchanged (except in relation to the public access rule)."

(c) a bill of exchange, and
(d) any other—
 (i) instrument that is evidence of a debt, or
 (ii) voucher, stamp or similar token or document which is capable of being exchanged for money, goods or services.

This is an extremely artificial definition of "money" in that it bears no relation to the ordinary meaning of the word. It is absurdly over-complex, given the limited importance of the exempt property rules. This definition is expressed to apply only for the purposes of s.806Z6(2), but it is also needed in s.809Y, so it has to be repeated there verbatim. It also applies in para 86 Sch 7 FA 2008, where it is incorporated by reference.

10.44.3 *Property "being in the UK"*

Section 809Z6(3) ITA defines "being in the UK":

> References to property being in the UK are references to the property—
> (a) being in the UK after being brought to, or received in, the UK in circumstances in which section 809L(2)(a) applies, or
> (b) being used in the UK in circumstances in which section 809L(2)(a) applies.

10.45 Public access rule

Section 809X(3) ITA provides:

> Property is exempt property if it meets the public access rule (see sections 809Z and 809Z1).

Section 809Z ITA provides a narrow exemption:

> **809Z Public access rule: general**
> (1) Property meets the public access rule if conditions A to D are met.
> (2) Condition A is that the property is—
> (a) a work of art,
> (b) a collectors' item, or
> (c) an antique,
> within the meaning of Council Directive 2006/112/EC (see, in particular, Annex IX to that Directive).

(3) Condition B is that—

(a) the property is available for public access at an approved establishment,

(b) the property is to be available for public access at an approved establishment and, in connection with its being so available, is in transit to, or in storage at, public access rule premises, or

(c) the property has been available for public access at an approved establishment and, in connection with its having been so available, is in transit from, or in storage at, public access rule premises.

(4) Property is "available for public access" at an approved establishment if the property is—

(a) on public display at the establishment,

(b) held by the establishment and made available to the public on request for viewing or for educational use, or

(c) held by the establishment for public exhibition in connection with the sale of the property.

(5) An "approved establishment" is—

(a) an approved museum, gallery or other institution within the meaning of Group 9 of Schedule 2 to the Value Added Tax (Imported Goods) Relief Order 1984, or

(b) any other person, premises or institution designated (or of a description designated) by the Commissioners.

(6) "Public access rule premises" are—

(a) premises in the UK at which the property is to be, or has been, available for public access, or

(b) other commercial premises in the UK used by the approved establishment for the storage of property in advance of its being, or after its having been, available for public access at the approved establishment.

(7) Condition C is that, during the relevant period, the property meets condition B for no more than—

(a) two years, or

(b) such longer period as the Commissioners may specify.

Long-term museum loans need HMRC approval: why should a donor bother?

(8) "The relevant period" means the period—

(a) beginning with the importation of the property, and

(b) ending when it ceases to be in the UK after that importation.

(9) "Importation" means the property being brought to, or received or used in, the UK in circumstances in which section 809L(2)(a) applies.

(10) Condition D is that the property attracts a relevant VAT relief (see section 809Z1).

809Z1 Public access rule: relevant VAT relief

(1) Property "attracts a relevant VAT relief" if any of conditions 1 to 4 are met.

(2) Condition 1 is that article 5(1) of the Value Added Tax (Imported Goods)

Relief Order 1984 applies in relation to the importation of the property by virtue of Group 9 of Schedule 2 to that Order (importation of works of art or collectors' pieces by museums etc).
(3) Condition 2 is that article 5(1) would so apply if the following requirements were disregarded—
  (a) the requirement that the importation be from a third country, and
  (b) the requirement that the purpose of the importation be a purpose other than sale.
(4) Condition 3 is that article 576(3)(a) of Commission Regulation (EEC) No 2454/93 (relief from import duties for works of art etc imported for the purposes of exhibition, with a view to possible sale) applies in relation to the importation of the property.
(5) Condition 4 is that article 576(3)(a) would so apply if the requirement that the importation be from a third country were disregarded.
(6) Where the property does not meet condition B in section 809Z at the time of its importation it is to be assumed for the purposes of this section that the property was imported on the day during the relevant period when the property first meets that condition.
(7) "The relevant period" and "importation" have the same meaning as in section 809Z and "imported" is to be read accordingly.

10.46 Personal use rule

Section 809X(4) ITA provides:

Clothing, footwear, jewellery and watches ~~that derive from relevant foreign income~~[107] are exempt property if they meet the personal use rule (see section 809Z2).

Section 809Z2 ITA provides:

(1) Clothing, footwear, jewellery or watches meet the personal use rule if they—
  (a) are property of a relevant person, and
  (b) are for the personal use of a relevant individual.
(2) In this section—
  (a) "relevant person" has the meaning given by section 809M, and
  (b) "relevant individual" means an individual who is a relevant person by virtue of section 809M(2)(a), (b), (c) or (d) (the individual with income or gains, or a husband, wife, civil

107 The words "that derive from RFI" were deleted with retrospective effect by the FA 2009.

partner, child or grandchild).

The words "*by virtue of section 809M(2)(a), (b), (c) or (d) (the individual with income or gains, or a husband, wife, civil partner, child or grandchild)*" are otiose because an individual who is a relevant person is necessarily a relevant person by virtue of those provisions; but no harm is done.

10.47 Repair rule

Section 809X(5)(a) ITA provides:

> Property of any description ~~that derives from relevant foreign income~~[108] is exempt property if— ...
> (a) the property meets the repair rule (see s.809Z3).

Section 809Z3 ITA provides:

> (1) Property meets the repair rule for the whole of the relevant period if, during the whole of that period, the property meets the repair conditions.
> (2) Property meets the repair rule for a part of the relevant period if—
> (a) during the whole of that part of that period, the property meets the repair conditions, and
> (b) during the whole of the other part of that period, or the whole of each other part of that period, the property meets the repair conditions or the public access rule.
> (3) Property meets the repair conditions if the property—
> (a) is under repair or restoration,
> (b) is in transit from a place outside the UK to repair rule premises, in transit between such premises, or in storage at such premises, in advance of repair or restoration, or
> (c) is in storage at such premises, in transit between such premises, or in transit from such premises to a place outside the UK, following repair or restoration.
> (4) "Repair rule premises" means—
> (a) premises in the UK that are to be used, or have been used, for the repair or restoration referred to in subsection (3)(b) or (c),

108 The words "that derive from RFI" were deleted with retrospective effect by the FA 2009.

or

(b) other commercial premises in the UK used by the restorer for the storage of property in advance of, or following, repair or restoration of property by the restorer.

(5) "Restorer" means the person who is to carry out, or has carried out, the repair or restoration referred to in subsection (3)(b) or (c).

(6) Property meets the repair conditions, or the public access rule, during the whole of a period, or the whole of part of a period, if the property meets those conditions or that rule—

(a) on the whole of, or on part of, the first day of that period or part period,

(b) on the whole of, or on part of, the last day of that period or part period, and

(c) on the whole of each other day of that period or part period.

(7) "The relevant period" has the same meaning as in section 809Z.

The relief applies only to the property being repaired. There is no relief for the service of repair. A remittance basis taxpayer would be mad to bring an asset to the UK in order to make use of UK repair or restoration services. Even if the importation of the asset did not give rise to a remittance[109] the payment for the repair would give rise to a remittance. All yacht and similar restoration work, for instance, from remittance basis taxpayers is lost to the UK. But there it is.

10.48 Temporary importation rule

Section 809X(5)(b) ITA provides:

Property of any description ~~that derives from relevant foreign income~~[110] is exempt property if— ...

(b) the property meets the temporary importation rule (see s.809Z4)

Although this refers to property "of any description" this does not include money. The words "of any description" are therefore otiose and

109 This requires that the asset was acquired out of RFI rather than REI or chargeable gains, and that the individual can prove this to be the case.

110 The words "that derive from RFI" were deleted with retrospective effect by the FA 2009.

misleading. Section 809Z4 ITA provides:

> (1) Property meets the temporary importation rule if the total number of countable days is 275 or fewer.
> (2) A "countable day" is a day on which, or on part of which, the property is in the UK by virtue of being brought to, or received or used in, the UK in circumstances in which section 809L(2)(a) applies (whether the current case, or a past case, when the property was so brought, received or used).
> (3) A day is not a countable day if, on that day or any part of that day—
> (a) the property meets the personal use rule,
> (b) the property meets the repair rule, or
> (c) the notional remitted amount in relation to the property is less than £1,000.
> (4) A day on which, or on part of which, the property meets the public access rule (the "relevant day") is not a countable day if any of conditions A to C is met.
> (5) Condition A is that the property meets the public access rule during the whole of the period of importation in which the relevant day falls.
> (6) Condition B is that—
>
> (a) the property does not meet the public access rule during the whole of the period of importation in which the relevant day falls, and
> (b) that period of importation—
> (i) begins with a period of no public access, and
> (ii) ends with a period of public access which immediately follows that period of no public access.
> (7) Condition C is that—
> (a) the property does not meet the public access rule during the whole of the period of importation in which the relevant day falls, and
> (b) during the parts, or each of the parts of the period of importation during which the property does not meet the public access rule it meets the repair conditions.
> (8) Section 809Z3(6) applies for the purposes of this section.
> (9) "Period of importation" means a period that—
> (a) begins when property is brought to, or received or used in, the UK in circumstances in which section 809L(2)(a) applies, and
> (b) ends when the property ceases to be in the UK after having been so brought, received or used.
> (10) "Period of no public access" means a period which is not a period

of public access and "period of public access" means a period during the whole of which property meets the public access rule

One needs to keep a lifetime record for every asset. EN FB 2008 provides:

30. If property meets the personal use rule, the repair rule or the public access rule then the time during which it meets any of those rules is taken into account in deciding whether it meets the temporary importation rule. So, for example, if an asset comes to the UK for repair, and that repair takes 75 days, then after the repair is complete it can be kept in the UK for a further 200 days under the temporary importation rule. Property to which the temporary importation rule applies remains exempt if, before the end of the 275 day period, it is then put on public display and meets the terms of the public access rule.

10.49 De minimis rule

Section 809X(5)(c) ITA provides:

Property of any description ~~that derives from relevant foreign income~~[111] is exempt property if ...
(c) the notional remitted amount (see s.809Z5) is less than £1,000,

Section 809Z5 ITA defines "notional remitted amount":

(1) This section applies for the purposes of sections 809X to 809Z6.
(2) The "notional remitted amount", in relation to property, is the amount of income that would be taken to be remitted to the UK in relation to the property (if section 809X did not apply in relation to the property).

Section 809Z5 continues with an unnecessary rule relating to sets of property:

(3) If—
(a) property forms part of a set, and
(b) only part of the set is in the UK,
the notional remitted amount is such part of the amount specified in

111 The words "that derive from RFI" were deleted with retrospective effect by the FA 2009.

subsection (4) as is just and reasonable having regard to the part of the set that actually is in the UK.
(4) That amount is the amount that would be taken to be remitted to the UK if the complete set had been brought to, or received or used in, the UK, at the same time as the part in question.

10.50 Exempt property clawback charge

Section 809Y ITA provides:

809Y Property that ceases to be exempt property treated as remitted
(1) Property that ceases to be exempt property is to be treated as having been remitted to the UK at the time it ceases to be exempt property.
(2) Property ceases to be exempt property in either of the following cases.
(3) The first case is where the whole or part of the exempt property is sold or otherwise converted into money[112] whilst it is in the UK.

This applies (illogically) even if the proceeds are received abroad. An exchange for a non-money asset is not a sale.

(4) The second case is where the property—
- (a) is exempt property only because it meets one or more of the relevant rules,[113]
- (b) ceases to meet that rule, or all of those rules, whilst it is in the UK, and
- (c) does not meet any other relevant rule.

10.51 Commencement

Para 81 Sch 7 FA 2008 provides:

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112 Section 809Y(5) provides a definition of "money" which is the same as in s.809Z6. (If the definition had been expressed to apply to the whole ITA remittance code the repetition would have been unnecessary.) The definition is discussed at 10.44.2 ("Money").

113 Section 809Y5) ITA provides:
"relevant rule" means-
(a) the public access rule,
(b) the personal use rule,
(c) the repair rule, and
(d) the temporary importation rule.

> The other[114] amendments made by this Part of this Schedule [i.e. part 1 which sets out the provisions discussed in this clause] have effect for the tax year 2008-09 and subsequent tax years.

FAQ Remittances (April 2008) provides:

> Will untaxed relevant foreign income that is brought into the UK by a non-domiciled individual before 6 April 2008 and remains in the UK as cash or is converted into an asset, give rise to a tax charge in 2008-09 on the grounds that it is a remittance in 2008-09?
> No. Any tax charge will be based on the rules operating in 2007-08.

10.52 Debit, credit and charge cards

This section considers whether the use of debit, credit and charge cards involves a remittance. The starting point is to understand the legal nature of debit, credit and charge cards. The following analysis draws on *The Law of Bank Payments*.[115]

On the use of a card, three contracts come into being. For present purposes the most important terms of the contracts are as follows:

(1) Cardholder and supplier
This is the contract for goods or services between the cardholder and the person from whom the cardholder purchases goods or services ("the supplier"). This contract is the same whether the cardholder pays by card or by cash.

(2) Card-issuer and supplier
The card-issuer undertakes to honour the card by paying the supplier.

(3) Card-issuer and cardholder
(a) A *debit* card is issued only by a bank. The contract between the card-issuer bank and cardholder authorises the bank to debit the cardholder's bank account with the amount of the card transaction.
(b) Charge and credit cards are different. Here the cardholder is

114 "Other" relates to provisions concerning employment-related securities not discussed here.

115 Brindle and Cox, Sweet & Maxwell, 3rd ed. 2004, para 4-013. In any particular case it is strictly necessary to review the specific terms governing the card concerned, but I expect that will not usually make any difference in practice. Store-issued cards are not discussed here.

> required to make a payment to the card-issuer. A *charge* card requires the cardholder to repay the balance outstanding after a set period.[116] A *credit* card allows the cardholder extended credit.

It is necessary to distinguish between use of cards to obtain (1) cash, and (2) goods or services.

10.52.1 *Cards used to obtain cash*

If a debit card is used to obtain cash in the UK from a foreign bank account which is in credit,[117] and the card is used at a branch of the bank which issued the card, then there is clearly a remittance of the money. The same applies if the cash is withdrawn from a bank which is not the card-issuing bank, because the third party bank acts as the agent for the card-issuing bank.

The use of a *charge* card to obtain cash in the UK from a foreign bank account is likewise a remittance. The time of the remittance is when the sum is debited from the account, not when the card is used. The position is the same if an individual uses a *credit* card to obtain cash in the UK

10.52.2 *Cards used to obtain goods or services*

Where a debit card is used to obtain goods or services in the UK, remittance condition A is satisfied. Payment of the debt to the card issuer out of income or gains satisfies remittance condition B.

10.52.3 *HMRC practice*

The RDR Manual provides:

> **Credit Cards and Debit Cards**
> *Credit card issued in the UK*

116 In the case of a bank-issued credit card, the issuer is normally authorised to debit the cardholder's bank account to meet a debt due on the card. But in practice this facility is not used unless needed (or the card effectively becomes a debit card).

117 If the effect of use of the card is to put an account into debit, there is obviously no remittance on ordinary principles, though the debt remittance rule will in principle apply when the overdrawn account is repaid.

> If a taxpayer who is chargeable on the remittance basis uses a UK credit card to pay for goods or services, either in the UK or overseas and he or she subsequently settles their credit card bill using foreign income or gains, the payment is a taxable remittance. See Chapter 3: Condition B – remittances derived from income or gain.
> The remittance does not have to be received in the UK by the taxpayer, it is sufficient that it is received by the credit card company in the UK.

This is not correct, but a remittance basis taxpayer should avoid a UK credit card in order to avoid dispute.

> *Credit card issued by an overseas bank or other financial institution*
> Where an overseas credit card is used in the UK, the cardholder is effectively authorising the credit card company to pay the bill for the goods or service in just the same way as if they had instructed the bank to make a payment directly to the person supplying the goods or services. The terms of credit card agreements may differ as to the moment of "indebtedness" between the cardholder and the credit card company. However the use of the credit card to pay for goods used or received in the UK, or services provided in the UK by, to or for the benefit of a relevant person will create a "relevant debt".
> The use of the individual's untaxed foreign income or gains to pay the credit card company in respect of the relevant debt will be a taxable remittance (see Chapter 3: Relevant debt).
> Any part of the payment that relates to non-UK goods or services provided outside the UK will not be chargeable.
> Interest and other such charges should be apportioned accordingly between UK and non-UK goods and services. In most cases a straight proportional split of the interest again expenditure type will be acceptable; for example if £400 of the debt relates to UK goods which are taxed as a remittance and £600 to non-UK goods and there is an interest charge in relation to that £1,000 debt of £10, then £4 of the interest is also a taxable remittance. However some cards may apply different rates where cash is withdrawn, or depending of date of purchase, in which case the taxpayer will need to compute the interest due on the "relevant debt" part of the payment only.
> Note that this section may apply to any credit card debt which the individual satisfies using their foreign income or gains, even if they are not the cardholder.
> *Debit card issued by an overseas bank or other financial institution*
> Payments for goods or services that are made using a debit card (for example a Visa debit card or one issued under the brand name "Cirrus")

issued by an overseas financial institution are treated in exactly the same way as a cash transaction.

This means that when goods or services are purchased in the UK using a debit card a taxable remittance is made to the extent of the amount of any overseas income or gains in the bank account. Likewise any cash withdrawals from shops or ATM machines in the UK are taxable cash remittances.

Payment by cheque drawn on an overseas account or by electronic transfer of any kind are also treated in exactly the same way as cash and are potentially taxable remittances of overseas income and gains.

10.53 Translating foreign currency into sterling

The RDR Manual provides:

Exchange Rates

Foreign income is converted into, and foreign gains are computed in, pounds sterling in all necessary calculations, for example in calculating whether or not unremitted income or gains falls above or below the "£2000 threshold" in a particular tax year.

All entries on the SA Return should be in pounds sterling.

Exchange rates for the end of the calendar year and the end of the tax year can be found at www.hmrc.gov.uk[118] whilst daily rates can be found at www.ft.com.

Foreign Income

Foreign income taxed on the arising basis is converted to pounds sterling at the exchange rate applicable on the day that it arose overseas.

Foreign income taxed on the remittance basis is subject to UK tax only when remitted to the UK. This income should be translated into sterling at the exchange rate prevailing on the date of remittance.

Example (remittance)

Christopher is a remittance basis user and has €8,000 income paid into his French bank account in June 2011 when the exchange rate is €0.705 to the pound, the equivalent of £5,642.

He remits all €8,000 of this foreign income on 1 May 2013 when the exchange rate was €0.681. He uses this 1 May exchange rate to convert this amount, giving a remitted amount of foreign income of £5,453; this is the amount he is taxed on.

Foreign chargeable gains are always calculated in pounds sterling at the

118 *www.hmrc.gov.uk/exrate/index.htm*.

rate of exchange that applied on the date the gain is realised. If the remittance of the gain takes the form of a transfer of funds from an overseas currency account to a UK sterling account there will be a separate gain on the disposal of the currency. This will tax any change in the value of the currency between the date of disposal and the date of remittance.

Foreign Chargeable Gains[119]

Foreign chargeable gains are calculated using sterling translations at the date of acquisition and the date of disposal. So the consideration received will be translated into sterling using the exchange rate at the time of disposal and allowable deductions will be translated using the exchange rate(s) at the time the expenditure was incurred (for example, when the asset was acquired). Thus the gain will be denoted in pounds sterling and will be the same whether taxed on the arising or the remittance basis.

If the gain is held as foreign currency, the taxable sterling amount of the gain will not change, but separate gains or losses may accrue if the foreign currency gains or loses value with respect to sterling before the gain is remitted.

Remittance basis users below the "£2,000 threshold"

An individual with unremitted foreign income or gains for a tax year of less than £2,000 can choose to use the remittance basis for that tax year without having to make a claim or pay the £30,000 remittance basis charge. (ITA07/s809D). See Chapter 2: Unremitted income and gains below £2,000 threshold

For the purposes of determining whether the amount of an individual's foreign income which is "not remitted" in a tax year is below £2,000 they obviously cannot apply the usual principle for remittance basis users of using the exchange rate at time of remittance. So, and only for the purposes of deciding whether ITA07/s809D applies, the individual's foreign income amounts should be converted to pounds sterling at the rate of exchange prevailing on the date that the unremitted income arose. Foreign gains are always calculated in pounds sterling.

However, where income credits are frequent throughout the year, you can accept calculations where the individual has chosen to convert their income using the average, or "mean" rate of exchange for the tax year in question. The amount of unremitted income arrived at using this method must not differ greatly from an amount which would be arrived at using "spot" rates, for example in times of high exchange rate volatility. If adopted, this method must be used consistently in future tax years for income from this source.

119 See 36.3 (Computation of gains in foreign currency).

This applies only to unremitted income (not gains) which is received in frequent instalments throughout the tax year and where a "spot rate" calculation would be an excessive undertaking, for example bank interest received daily or weekly.

Note - If any of this foreign income is later remitted to the UK, it will be liable to UK tax at that point. The rate of exchange that should be used when declaring the remittance is the actual rate of exchange on the date of remittance into the UK. This will mean that the same foreign income may be converted at different exchange rates, depending on the reason for the conversion.

Nominated Income and Gains

Nominated income and gains are charged to UK tax on the arising basis (see Chapter 2: Making a Nomination). This means that any foreign income that is nominated for the purpose of the Remittance Basis Charge is converted to pounds sterling at the exchange rate that applied on the date the income arose.

Foreign chargeable gains are always calculated in pounds sterling at the rate of exchange that applied on the date the gain is realised.

Example

F is a non-domiciled individual who is subject to the Remittance Basis Charge. She decides to nominate €20,000 of foreign income. The exchange rate on the date the income arose was €0.744 to the pound. She uses this rate to calculate the equivalent nominated amount of foreign income in sterling, which is £14,880.

The commonsense approach ought to apply whenever foreign currency conversion computations are required for any tax purpose.[120]

10.54 Property held jointly by spouses

Section 836 ITA provides:

(1) This section applies if income arises from property held in the names of individuals—

(a) who are married to, or are civil partners of, each other, and

(b) who live together.

(2) The individuals are treated for income tax purposes as beneficially entitled to the income in equal shares.

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120 Thus maintaining the practice in the former Inspectors Manual set out in the 6th edition of this work.

How does this interrelate with the remittance basis? Suppose:

(1) Property is held in the names of H and W, but belongs in equity to H alone.
(2) Section 836 applies so that half the income is deemed to be the income of W.
(3) W is a remittance basis taxpayer.

Income of W arising before 2008/09, being merely deemed income, could not be remitted and could not be subject to tax. But income arising from 2008/09 counts as remitted if it is remitted by H, since H is a relevant person in relation to W.

10.54.1 *Joint accounts*

The RDR Manual provides:

> **Joint Accounts**
> Where a remittance basis user has an offshore bank account held jointly with another person there maybe additional difficulties in identifying the nature of the monies in the account, and any transfers of monies from the account.
> Earned Income
> Employment income and pensions are not regarded as "joint property". Any foreign earnings or foreign pension income (taxed as relevant foreign income) is attributable only to the employee or pensioner to whom they "belong".
> Income from jointly held property
> ITA07/s836(2) provides that where a married couple or civil partners are living together and income arises from property held in their joint names, both individuals are treated for income tax purposes as beneficially entitled to one-half of the income regardless of their actual respective beneficial entitlements, unless they make a joint declaration that it shall be otherwise under ITA07/s837. See Independent Taxation Manual IN115+ for further details.
> This general "equal division" rule at ITA07/s836(2) does not apply in some cases (referred to in ITA07/s836 as "exceptions").
> These are:
> • Exception A - any income to which neither of the individuals is beneficially entitled
> • Exception B – where the spouses/civil partners make a joint election to HMRC under the terms of ITA07/s837 that one of them is beneficially entitled to the income to the exclusion of the other or they are both entitled to the income in unequal shares
> • Exception C - partnership income

- Exception D - income from a UK property business
- Exception E - distributions from close companies
- Exception F – where one of the persons is beneficially entitled to the income but it is treated as being the income of someone else under any other provision of the Taxes Acts

Broadly then, unless the individuals have made a declaration otherwise, foreign income arising from jointly held property will be regarded as belonging to each individual in an equal (that is usually a 50:50) share.

Any interest arising on the jointly held offshore bank account will be split equally between the account holders.

Of course married couples or civil partners may also hold assets separately; and they can divide up joint assets so that they hold them separately for the future. In these circumstances each spouse or civil partner is then taxed on the income from the assets each holds in his or her own name, in the same way as for "earned income".

Analysing the account

Where an individual has a "joint account" with someone else and one or both of them chooses to be taxed on the remittance basis it is necessary to fully analyse the account (with due regard being given to the "exceptions" identified above). You will need to do this in order to apply Step 1 ITA07/s809Q(3) (see Chapter 5: Mixed funds) which deals with transfers from mixed funds and requires you to find each of the categories of the remittance basis user's income and gains in the mixed fund. A joint account will almost certainly be a mixed fund.

Analyse the account by putting each credit to the account into separate columns, divided between each individual.

Likewise with the debits; transfers out of the account that are clearly made by or for one or other of the individuals and intended to be made out of "their" share of the income should be debited "under" their column.

"Joint" expenses, for example items such mortgage payments where the debt is held jointly, or council tax bills and so on may, if appropriate, be split equally between each individual. Alternatively, such debits may be fully appropriated to just one of the account holders if that reflects the reality of their joint financial arrangements; for example it may be that only one partner is working and contributes most of the "credits" to the account in the form of their income. In such circumstances it may be more appropriate to attribute all expenditure to that partner in so far as the overall balance of the account permits. When separating the account in this way it is important that the overall balance remains consistent (see below).

In practice you should try to take the most pragmatic approach that best reflects the reality of both individuals' situations.

Cases where only one account holder is a remittance basis user

Individuals who are not using the remittance basis are liable to tax on the arising basis, so they will, where appropriate, have paid UK tax in respect of their share of the income and gains that have been credited to the joint account in the tax year. Because UK tax has been (or will be) paid by that individual he or she may bring to the UK or otherwise use **their** share of the funds that are in the account in any way they wish without triggering an additional tax charge.

However, if at any time during the year they bring to the UK or otherwise use amounts in excess of **their** share of the funds in the joint account at that point in time then they will be regarded as using their partner's income or gains instead.

Example:

An offshore bank account was opened on 20 June. It is held jointly by A and B, who are civil partners. A is a remittance basis user in this year. The account shows:

Date	**Credit**	**Debit**	**Balance**	**Attributable to**
20 June	£2,000		£2,000	A – foreign earnings
27 June	£1,000		£3,000	A – relevant foreign income
1 July		£800	£2,200	B – cash taken out in London
27 July	£90		£2,900	B – UK rental income

In analysing the account you need to look at what was in the account i**mmediately before** each debit. In this case, the cash withdrawn by B in London on 1 July can only be attributed to A's income credits and, as B is relevant person, A will be regarded as having remitted that £800. See also Chapter 5: Remittances from mixed funds).

Remember that in most cases the account holders are likely to be relevant persons in relation to each other, so even transfers from the non-remittance basis using individual may be a taxable remittance on the other partner if it is regarded as consisting of or deriving from the other partner's foreign income or gains.

<u>Cases where both account holders are remittance basis users</u>

You will still need to analyse the account in order to determine which transfers from the mixed fund are taxable remittances, and to determine which account holder is liable to pay any tax due. Again, you should try to take the most pragmatic approach that best reflects the reality of the situation.

Once the account has been split between the individual account holders, any taxable remittances (see Chapter 3: Meaning of remittance) of the foreign income or gains that are the property of the remittance basis user are subject to the normal "ordering" rules that apply to remittances from a "mixed fund".

The following example demonstrates the principles of analysing a joint account and then determining whether the "transfers" are a taxable remittance from a mixed fund. You will also need to see Chapter 5: Remittances from mixed funds.

Example

Erica and John have been married for several years, and currently live in the UK. John is domiciled within the UK. Erica is not domiciled in the UK. Erica decides to claim the remittance basis for this year.

Both Erica and John have employment income that is credited to the account. For most of the year Erica works in the UK but she also has a separate part-time employment with a foreign employer outside of the UK for part of the year.

Erica and John have a joint bank account in the Isle of Man. Into this account is paid both of their salaries, and some bank interest. They use the account to pay their household bills, including the mortgage on their jointly owned UK home. The amounts credited to the account are as follows:

Date		Credit	Debit	Balance
	Opening Balance			£0
30 April	UK salary (Erica)	£3,000		£3,000
30 April	UK salary (John)	£2,000		£5,000
30 April	Overseas salary (not subject to foreign tax) (Erica)	£2,000		£7,000
30 April	Bank interest not taxed	£200		£7,200
1 May	Direct debit - UK energy coy		(£200)	£7,000
5 May	Cash withdrawal (UK)		(£1,000)	£6,000
10 May	Cash withdrawal (UK)		(£1,000)	£5,000
17 May	Direct debit - mortgage		(£3,000)	£2,000
31 May	UK salary (Erica)	£3,000		£5,000
31 May	UK salary (John)	£2,000		£7,000
31 May	Overseas salary (not subject to foreign tax) (Erica)	£800		£7,800
1 June	Direct debit - UK energy coy		(£200)	£7,600
5 June	Cash withdrawal (UK)		(£1,000)	£6,600
10 June	Cash withdrawal (UK)		(£800)	£5,800
17 June	Direct debit - mortgage		(£3,000)	£2,800

The credits and the debits account can be analysed between Erica and John with the following results:

		Erica			John			Overall Account Balance
		Credit	**Debit**	**Balance**	**Credit**	**Debit**	**Balance**	
30 April	UK salary **Note 1**	£3,000		£3,000				£3,000

30 April	UK salary **Note 1**				£2,000		£2,000	£5,000
30 April	Overseas salary	£2,000		£5,000				£7,000
30 April	Bank interest **Note 2**	£100		£5,100	£100		£2,100	£7,200
1 May	Direct debit to UK energy coy		£100	£5,000		£100	£2,000	£7,000
5 May	Cash w/drawn (UK) **Note 3**		£1,000	£4,000				£6,000
10 May	Cash w/drawn(UK) **Note 3**					£1,000	£1,000	£5,000
17 May	Direct debit – mortgage **Note 4**		£2,000	£2,000		£1,000	£nil	£2,000
31May	UK salary	£3,000		£5,000				£5,000
31May	UK salary				£2,000		£2,000	£7,000
31May	Overseas salary	£800		£5,800				£7,800
1 Jun	Direct debit to UK energy supplier		£100	£5,700		£100	£1,900	£7,600
5 Jun	Cash w/drawn (UK)		£1,000	£4,700				£6,600
10 Jun	Cash w/drawn (UK)					£800	£1,100	£5,800
17 Jun	Direct debit mortgage **Note 4**		£1,900	£2,800		£1,100	Nil	£2,800

Note 1:

Earned income is attributed to the employee only

Note 2:

Because this is a joint account, the interest arising on it is split equally between Erica and John.

Note 3:

This money is withdrawn in the UK by John and Erica to meet their own personal expenditure, for example travel, meals and so on.

In this example John's "personal expenditure" can be attributed to his "income" credits into the account. If instead the withdrawals by John were regarded as coming from Erica's "portion" of the pot, because John is a relevant person and money has been brought into the UK by a relevant person (so Condition A of ITA07/s809L(2)(a) is met (see Chapter 3: Condition A – money and property) there might still be a taxable remittance, with the tax due payable by Erica (see below).

Note 4:

The mortgage payment is made to a UK bank. The mortgage is held on John and Erica's UK home and is a joint debt of Erica and John, and each contributes half of the cost. To the extent that John has money in the account it can be accepted that he has used his taxed income to pay his share of the mortgage.

Money has been brought into the UK to pay this mortgage, so Condition A of ITA07/s809L(2)(a) is met (see Chapter 3: Condition A – money and property) and there is a "transfer" from a mixed fund.

Because this is a mixed fund ITA07/s809Q(2) is in point (see Chapter 5: Remittances from mixed funds). So in order to determine whether this money is regarded as consisting of, or deriving from, a remittance basis users' foreign income or gains (such that there is a taxable remittance under Condition B of ITA07/s809L(2)(a)) it is necessary to look at the composition of the fund immediately before the "transfer".

This shows that £2,000 of the mortgage payment made on 17 May must be attributable to Erica's income or gains in the mixed fund. Similarly, £1,900 of the mortgage payment of 17 June is attributable to Erica's income in the mixed fund.

So far as Erica is concerned, her share of the account shows (for the purposes of calculating if and to what extent she has made a taxable remittance of her overseas income) is as follows:

		Credit	**Debit**	**Category (S809Q(4))**
30 April	UK salary	£3,000		**Para (a)**
30 April	Overseas salary (not subject to foreign tax)	£2,000		**Para (b)**
30 April	Bank interest	£100		**Para (d)**
1 May	Direct Debit (energy coy		£100	
10 May	Cash		£1,000	
17 May	Direct Debit (mortgage)		£2,000	

31 May	UK salary	£3,000		**Para (a)**
31 May	Overseas salary	£800		**Para (b))**
1 June	Direct Debit (energy)		£100	
5 June	Cash		£1,000	
17 June	Direct Debit (mortgage)		£1,900	

Applying the rules at ITA07/s809Q (see Chapter 5: Remittances from mixed funds) to the first "transfer" to the UK, which is the payment to the energy company on 1 May. **Remember the mixed fund rules require the account to be analysed before every "transfer"**

<table>
<tr><td colspan="3">Step 1 – Identify the "amount of transfer" in the relevant year</td><td>£100</td></tr>
<tr><td rowspan="3">Analyse mixed fund to identify the separate amounts of income, capital gains and capital present for each tax year immediately before the date of the transfer</td><td colspan="2">Para (a) Employment income (UK employment income)</td><td>£3,000</td></tr>
<tr><td colspan="2">Para (b) Relevant foreign earnings (not subject to a foreign tax)</td><td>£2,000</td></tr>
<tr><td colspan="2">Para (d) Relevant foreign income (not subject to a foreign tax)</td><td>£100</td></tr>
<tr><td colspan="2">Step 2 – Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund</td><td>Para (a)</td><td>£3,000</td></tr>
<tr><td colspan="4">Step 3 If the amount at Step 2 is equal to or more than the amount of the transfer (the last time sep 3 was completed) treat the whole of the remaining amount of the transfer as coming from that item of income or gain</td></tr>
</table>

So Erica's transfer of £100 is treated as coming from her UK employment income; it is not thus a "taxable" when brought into the UK.

Then apply the rules at ITA07/s809Q (see Chapter 5: Remittances from mixed funds) to the next "transfer" to the UK, which is the cash withdrawal.

<table>
<tr><td colspan="2">Step 1 – Identify the "amount of transfer" in the relevant year</td><td>£1,000</td></tr>
<tr><td rowspan="2">Analyse mixed fund to identify the separate amounts of income, capital gains and capital present for each tax year immediately before the date of the transfer</td><td>Para (a) Employment income (UK employment income)</td><td>£2,900</td></tr>
<tr><td>Para (b) Relevant foreign earnings (not subject to a foreign tax)</td><td>£2,000</td></tr>
</table>

	Para (d) Relevant foreign income (not subject to a foreign tax)	£100
Step 2 – Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund	**Para (a)**	£1,900
Step 3 If the amount at Step 2 is equal to or more than the amount of the transfer (the last time step 3 was completed) treat the whole of the remaining amount of the transfer as coming from that item of income or gain		

So Erica's transfer of £1,000 is treated as coming from her UK employment income; it is not thus a "taxable" when brought into the UK.
Then apply the rules at ITA07/s809Q (see Chapter 5: Remittances from mixed funds) to the next "transfer" to the UK, which is the mortgage payment.

Step 1 – Identify the "amount of transfer" in the relevant year		**£2,000**
Analyse mixed fund to identify the separate amounts of income, capital gains and capital present for each tax year immediately before the date of the transfer	**Para (a)** Employment income (UK employment income)	£1,900
	Para (b) Relevant foreign earnings (not subject to a foreign tax)	£2,000
	Para (d) Relevant foreign income (not subject to a foreign tax)	£100
Step 2 – Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund	**Para (a)**	£1,900
Step 3 Where the amount transferred is greater than the amount identified at Step 2 the amount transferred is treated as reduced by the amount identified in Step 2.		£2,000 - £1,900 = £100
Step 4 - Find the next paragraph/amount for that tax year. In the order of preference listed above repeat Steps 2 and 3.		
Step 2 - repeated	**Para (b)**	£100
Step 3 If the amount at Step 2 is equal to or more than the amount of the transfer (the last time step 3 was completed) treat the whole of the remaining amount of the transfer as coming from that item of income or gain		

£1,900 of the transfer is treated as coming from Erica's UK employment income; it is not thus a "taxable" when brought into the UK. The remaining £100 is treated as a remittance of £100 of Erica's untaxed overseas earnings.

10.55 Avoiding remittances: basic tax planning

The best way to avoid any question of a remittance basis liability is simple in concept but administratively cumbersome. It is to keep in separate accounts (or sub-accounts):

(1) Income taxable at 40% on remittance.
(2) Income taxable at lower rates on remittance (because of DTR).
(3) Capital including gains with DTR.
(4) Capital including gains without DTR.
(5) Tax free capital.

Funds can then be remitted from accounts with a lower or nil rate of tax. Income taxable at the top rate can be used abroad or reinvested.

10.56 Transitional rules for remittance in specie

Under the pre-2008 RFI remittance basis, there was no remittance of RFI if property was remitted *in specie* (not in the form of money.) This is now caught by remittance condition B.

10.56.1 *Property remitted to UK before April 2008*

Para 86 Sch 7 FA 2008 provides a transitional relief:

> (1) Section 809L of ITA 2007 (meaning of "remitted to the UK") has effect subject to this paragraph.
> (2) If, before 6 April 2008, property (including money) consisting of or deriving from an individual's relevant foreign income was brought to or received or used in the UK by or for the benefit of a relevant person, treat the relevant foreign income as not remitted to the UK on or after that date (if it otherwise would be regarded as so remitted).

At first sight the words "including money" are rather odd, because if *money* is remitted to the UK before 2008/09, it is in principle taxable remittance. But the wording does not make sense, because para 82(5) incorporates a definition of money which is artificial in that it bears no relation to the normal meaning of the word.[121]

Suppose:

(1) T borrowed to purchase an asset (not "money") and acquired the asset before 6 April 2008.
(2) T receives the asset in the UK after 6 April 2008.
(3) T repays the borrowing out of RFI after 6 April 2008.

The transitional relief does not apply because the purchased asset is not derived from the RFI.

FAQ Remittances (April 2008) provides:

> Is it true that assets in the UK owned by a non-domiciled individual which were purchased out of untaxed relevant foreign income will be taxed if the asset is still in the UK on 6 April 2008?
> No. Assets owned by a non-domiciled individual that were purchased using untaxed foreign income and that are already in the UK will not give rise to a tax charge as a remittance on 6 April 2008. *If the asset is sold in the UK, then a tax charge can arise under existing rules and that charge will remain.*

The italicised sentence is inaccurate. Para 86(2) provides a complete exemption. This may reflect a change of mind since the FAQ was written as the relief was rewritten at Report Stage. The result is something of a windfall, but there it is.[122]

10.56.2 *Property acquired before 12 March 2008*

Para 86(3) Sch 7 FA 2008 provides:

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121 Para 86(5) provides: "money" has the same meaning as in s.809Y of ITA; see 10.44.2 ("Money").

122 For completeness, FAQ Remittances (April 2008) provides:

> "Where a non-domiciled individual not resident in the UK, has purchased assets abroad out of income that has not been taxed in the UK, then moves to the UK and becomes resident, will the importation of those assets in the first year be taxed as a remittance?
> No. As the untaxed income arose while the individual was not UK resident, there is no charge unless the proposed new section 832A ITA 2007 applies (temporary foreign residence)."

This is obvious.

> If, before 12 March 2008, property (other than money) consisting of or deriving from an individual's relevant foreign income was acquired by a relevant person, treat the relevant foreign income as not remitted to the UK on or after 6 April 2008 (if it otherwise would be regarded as so remitted).

Para 86(2) provides relief where property (including "money") was *remitted* before 6 April 2008.

Para 86(3) provides relief where property (excluding "money") was *acquired* before 12 March 2008, regardless of the date of remittance.

If this is taken literally, it disapplies the remittance basis for all RFI in a non-"money" form! I think it is safe to say that could not have been the intention of the drafter, but to read it in any other way would not be to construe the words but to rewrite them. I see no satisfactory solution to this mess, but possibly the least unsatisfactory is to say that since Parliament has failed to express any intention with sufficient clarity, it should be dismissed as meaningless. The alternative is to take the words to mean what they say.

10.57 Transitional loan relief

Para 90 Sch 7 FA 2008 provides a relief which I call "**transitional loan relief**". Para 90(1) provides:

> This paragraph applies if—
> (a) before 12 March 2008, money was lent to an individual outside the UK,
> (b) the loan was made for the purpose of enabling the individual to acquire an interest in residential property in the UK (and for no other purpose), and
> (c) before 6 April 2008—
> (i) the money was received in the UK,
> (ii) the individual used the money to acquire an interest in residential property in the UK ("the interest"), and
> (iii) repayment of the debt for the money ("the debt"), or of payments made under a guarantee of that repayment ("the

guarantee”),[123] was secured on the interest.

Para 90(2) provides the relief:

> Relevant foreign income of the individual used outside the UK before 6 April 2028 to pay interest on the debt is treated as not remitted to the UK.

Thus:

(1) Transitional loan relief is restricted to RFI (and does not apply if employment income or gains are used to pay the interest).
(2) The relief is restricted to loans for residential property; (it does not apply even to loans for home improvements).
(3) The relief is restricted to secured loans.

Para 90(3) Sch 7 FA 2008 restricts the relief:

> If, at any time on or after 12 March 2008—
> (a) any term upon which the loan was made, or any term of the guarantee, is varied or waived,
> (b) repayment of the debt, or of payments made under the guarantee, ceases to be secured on the interest,
> (c) repayment of any other debt is secured on the interest or is guaranteed by the guarantee, or

123 Para 90(6) Sch 7 FA 2008 defines “guarantee”:
“In this paragraph ‘guarantee’ includes an indemnity, and ‘guaranteed’ is to be read accordingly.”
March 2009 Qs & As provides:
Q20: We would also welcome confirmation that the provisions in paragraph 90(1)(c)(iii) apply to a non-UK loan drawn down before 12 March 2008 where there are two (or more) guarantees in place for repayment of the debt, of which only one is secured on the UK residential property.
A: We can only reply in general terms to this query. The way in which this provision will apply will be determined in practice by the details of the particular loan or guarantee transactions in question. We would generally treat repayments of a debt secured on the property itself as falling within the provisions of paragraph 90 regardless of what guarantees might also exist. Likewise, any repayments made under such a guarantee will also be covered by the paragraph. However, any repayments made under a guarantee which is not secured on the UK property will not be covered.

> (d) the interest ceases to be owned by the individual,
>
> sub-para (2) does not apply in relation to relevant foreign income used as mentioned there after that time.

I am unable to see the point of conditions (b) and (c).

Suppose:

(1) H borrowed before 2008 to purchase property.
(2) W used her RFI to pay this interest.

Transitional loan relief does not apply as W is not the individual to whom the money is lent.

The effect of the relief in some cases will be to impose a severe tax penalty on a foreign domiciliary who wishes to move house. It also makes re-financing impossible (from 12 March 2008) as the relief ceases to apply.

Para 90(4) Sch 7 FA 2008 provides:

> If—
>
> (a) before 12 March 2008, money was lent to the individual outside the UK ("the subsequent loan"),
>
> (b) the subsequent loan was made for the purpose of enabling the individual to repay—
>
> (i) the loan mentioned in sub-para (1), or
>
> (ii) another loan in relation to which sub-paras (2) and (3) apply (by virtue of this sub-paragraph),
>
> and for no other purpose, and
>
> (c) before 6 April 2008—
>
> (i) the individual used the money to repay the loan referred to in para (b)(i) or (ii), and
>
> (ii) repayment of the subsequent loan, or of payments made under a guarantee of that repayment, was secured on the interest,
>
> sub-paras (2) and (3) apply in relation to the subsequent loan (and for this purpose references there to the debt or the loan are to be read as references to the subsequent loan).

10.57.1 *What is the loan for?*

March 2009 Qs & As provides:

> **Q19:** It would be helpful to understand more fully the meaning of the requirement in paragraph 90(1) (b) that the loan was made for the purpose of acquiring an interest in residential property "and for no other purpose" and in particular to what extent any other purpose might cause the whole loan to fall outside paragraph 90.
>
> In a situation where money is lent before 12 March 2008 from a non-UK bank to an individual (resident but not domiciled in the UK) outside the UK under a facility letter for £5 million. £4.5 million of the facility is initially drawn down and the money used by the individual to purchase a residential property in the UK. Assume for these purposes that the loan was secured on a UK residential property.
>
> Subsequently (and before 12 March 2008) a second tranche of £0.5 million was drawn down under the same loan facility, also outside the UK. The money from the second draw down was used to refurbish the residential property purchased by the first draw down.
>
> **A:** The effect of paragraph 90(1) is to provide transitional provisions for loans made for the purpose of acquiring an interest in residential property in the UK. In this scenario, there are effectively two separate loans, even though they were made under a single facility letter: it is the drawdown of the money rather than the facility letter which constitutes the lending of the money. Therefore the first £4.5m drawn-down was money lent to the individual before 12 March and used to purchase a UK residential property and for no other purpose and was secured on that interest. That being the case, the transitional conditions will apply if, and to the extent which, relevant foreign income is used to pay interest on the debt.
>
> However, because the second £0.5m tranche of money was used to refurbish the property rather than to acquire an interest in it, it is does not meet the conditions set out paragraph 90(1)(b). Therefore, any relevant foreign income which is used to pay interest on this part of the debt will be treated as a taxable remittance in the UK.

What if a loan meets the conditions in part? It appears that HMRC accept there can be an apportionment. March 2009 Qs & As provides:

> **Q21**: We would welcome guidance on the principles for calculating the interest on that part of the debt which can be paid from relevant foreign income of the individual outside the UK without triggering a taxable remittance (under paragraph 90(2)). We suggest a reasonable approach is to calculate the interest element based on the loan capital ratio (ie that part of the loan which meets the paragraph 90 conditions over total capital of the loan facility), and apply that ratio to the total amount of interest due.

> **A**: The approach you suggest is, in broad terms, one which HMRC would consider acceptable, with the obvious caveat that the actual approach in any specific case would depend entirely on the terms of the loans.

10.57.2 *Varying a loan*

The relief is disapplied if:

> any term upon which the loan was made, or any term of the guarantee, is varied or waived

FAQ Remittances (April 2008) states that the relief only applies so long as "no further advances are made on or after 12 March". This is not correct, but if any further advances are made care must be taken with the documentation to ensure that there is a new loan (not a variation of an existing one) and the debt is not secured on the individual's interest in the property.

December 2008 Qs & As confirms this:

> **Q21** Where a taxpayer has an existing mortgage with a non-UK institution, secured on a residential property in the UK, with interest payments made out of untaxed foreign income and that existing facility includes an open credit line, would a draw-down of funds after 12 March 2008 constitute a "further advance"? Just to clarify, no variation to the pre-12 March 2008 terms and conditions of the loan would occur, the draw-down is made under the existing facility.
> If such a draw-down would constitute a "further advance", can you clarify whether the payments of interest from that point being treated as remittances would comprise (a) only those (pro rated) interest payments which relate to the further sum advanced or (b) all payments of interest on the full loan sum (ie the pre-existing loan sum plus the further advanced sum)?
> **A** A draw down of funds after 12 March 2008 would constitute a further advance and cannot be exempted from tax under para 90 because the monies have to have been lent before 12 March 2008. Only the interest payments in relation to the loan received before 11 March 2008 would be eligible for exemption from tax.

December 2008 Qs & As provide:

> **Q29** If an individual has an offshore mortgage with a two year fixed rate, will the grandfathering provision only last until the two year fixed rate period ends?
> **A** Assuming the mortgage meets the other conditions for grandfathering whether relief would continue to apply after the fixed rate period ends would depend on the exact terms of the relevant loan agreement which was entered into before 12 March 2008. If, after the two year point was reached, the existing terms of that agreement would need to be amended, or a new agreement entered into (including a side agreement to the existing loan agreement), there would be a variation of the terms of the original agreement and the grandfathering provisions would no longer apply after that time. But if the loan agreement automatically provided for the move from a fixed rate to a variable rate, that would not on the face of it result in a variation in the agreement, and if so relief would continue.

In practice in the usual case the move to a floating rate will happen automatically, and the relief will continue to apply.

10.57.3 *When is the loan made?*

December 2008 Qs & As provides:

> **Q 27 Remittance basis - offshore borrowing** If a mortgage was arranged and contracts for the purchase of the relevant property were exchanged in October 2007 but completion was not until March 31 2008 and the mortgage funds were not drawn down until completion, would this be considered to be an existing mortgage as at 12 March 2008?

HMRC refuse to answer the question:

> **A** The conditions for the grandfathering relief to run would only be met if the "lending" took place before 12 March 2008, providing the funds were received in the UK and used to acquire the interest in the property in question before 6 April 2008. The answer depends on the terms and conditions of the mortgage arrangement, which determine the point at which the funds are regarded as "lent".

The answer does not depend on the terms and conditions of the mortgage arrangement. It depends on when the money was lent which the question states was not until completion. Thus transitional loan relief is not available. This is of course extremely unfair: it may be because of the obvious unfairness that HMRC chose not to answer the question. But the same question is asked later in the Qs & As, and receives a straight answer:

> **Q** A UK non-domiciled came to the UK in July 2007. He made an offer to purchase a residential property in the UK in November 2007. The deal became unconditional in February 2008 and entry was agreed for 16 March 2008. He has an offshore mortgage and the loan offer was made prior to 12 March but of course not drawn until 16 March. Does para 90 of Schedule 7 of FA 2008 apply?
> **A** The grandfathering provisions for offshore mortgages apply only where the loan was made before 12 March 2008. This means that the money had to be in the hands of the non-domiciled individual (or for example in the Solicitor's client account) before that date.

10.57.4 *Joint accounts*

March 2009 Qs & As provides:

> **Q22:** We would welcome confirmation that the remittance protection in paragraph 90 applies where a husband and wife (or civil partners), both of whom are resident but not domiciled in the UK, have a joint non-UK bank account and a joint offshore mortgage. The offshore mortgage meets the conditions set out in paragraph 90 (1).
> If only one spouse (or civil partner) has relevant foreign income and that spouse makes a payment into a joint non-UK bank account using that relevant foreign income and these funds are then used to pay the interest on the offshore mortgage, then it is our understanding that such payment of interest will not constitute a remittance of any of the relevant foreign income by virtue of paragraph 90.
> **A:** We are not able to provide the confirmation you are seeking because whether there is a taxable remittance in this situation will depend on the composition of the joint account and the way in which the mixed fund rules section 809Q apply to it. Therefore we can again only answer in general terms.
> Provided the payment of relevant foreign income by one spouse or civil partner into the joint account is the only income within that account (in other words, section 809Q is not in point) which is then used to pay the interest on the mortgage which meets the conditions within paragraph 90(1), then that payment would also fall within paragraph 90.

10.57.5 *Meaning of residential property*

Para 90(5) Sch 7 FA 2008 provides:

> In this paragraph "residential property" has the same meaning as in Part 4 of FA 2003 (see section 116 of that Act).

So we turn to s.116 FA 2003 to find the complex definition:

> (1) In this Part "residential property" means—
> (a) a building that is used or suitable for use as a dwelling, or is in the process of being constructed or adapted for such use, and
> (b) land that is or forms part of the garden or grounds of a building within para (a) (including any building or structure on such land), or
> (c) an interest in or right over land that subsists for the benefit of a building within para (a) or of land within para (b);
>
> and "non-residential property" means any property that is not residential property. This is subject to the rule in subsection (7) in the case of a transaction involving six or more dwellings.
>
> (2) For the purposes of subsection (1) a building used for any of the following purposes is used as a dwelling—
> (a) residential accommodation for school pupils;
> (b) residential accommodation for students, other than accommodation falling with subsection (3)(b);
> (c) residential accommodation for members of the armed forces;
> (d) an institution that is the sole or main residence of at least 90% of its residents and does not fall within any of paras (a) to (f) of subsection (3).
>
> (3) For the purposes of subsection (1) a building used for any of the following purposes is not used as a dwelling—
> (a) a home or other institution providing residential accommodation for children;
> (b) a hall of residence for students in further or higher education;
> (c) a home or other institution providing residential accommodation with personal care for persons in need of personal care by reason of old age, disablement, past or present dependence on alcohol or drugs or past or present mental disorder;
> (d) a hospital or hospice;
> (e) a prison or similar establishment;
> (f) a hotel or inn or similar establishment.
>
> (4) Where a building is used for a purpose specified in subsection (3), no account shall be taken for the purposes of subsection (1)(a) of its suitability for any other use.
>
> (5) Where a building that is not in use is suitable for use for at least one of the purposes specified in subsection (2) and at least one of those specified in

subsection (3)—

(a) if there is one such use for which it is most suitable, or if the uses for which it is most suitable are all specified in the same sub-paragraph, no account shall be taken for the purposes of subsection (1)(a) of its suitability for any other use,

(b) otherwise, the building shall be treated for those purposes as suitable for use as a dwelling.

(6) In this section "building" includes part of a building.

(7) Where six or more separate dwellings are the subject of a single transaction involving the transfer of a major interest in, or the grant of a lease over, them, then, for the purposes of this Part as it applies in relation to that transaction, those dwellings are treated as not being residential property.

(8) The Treasury may by order—

(a) amend subsections (2) and (3) so as to change or clarify the cases where use of a building is, or is not to be, use of a building as a dwelling for the purposes of subsection (1);

(b) amend or repeal subsection (7) and the reference to that subsection in subsection (1).

Any such order may contain such incidental, supplementary, consequential or transitional provision as appears to the Treasury to be necessary or expedient.

10.57.6 *Critique*

No reasons were ever given for the strikingly restricted features of transitional loan relief, so one is left to speculate. If the purpose of the relief is to assist those who have taken out loans on the assumption that the law which existed from 1956 to 2008 would govern the taxation of the interest, and who may now be unable to pay the interest, each of these restrictions are irrational. I surmise that the object was specifically to bolster the residential property market by preventing forced sales by foreign domiciliaries who are made unable to repay their mortgages: if so only the restriction of relief to RFI is irrational.[124]

Why the restriction to residential property? The reason may be that loans to acquire let property had a benevolent treatment under the pre-2008 remittance basis: the interest could be paid out of foreign income without a remittance, but the interest was deductible against the rent for the purpose of computing the profits of the UK property business. Similar points apply to other cases where interest is deductible. But if that is the aim then it is achieved in a very rough and ready manner. Those who borrowed to buy

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124 It was probably based on the erroneous belief that under the pre-2008 rules, employment income or gains used to pay interest were regarded as remitted.

a house and improve it are particularly unfairly treated.

Perhaps the matter was not thought out at all and the only thinking was to provide the smallest possible transitional relief consistently with appeasing the banking lobby. Of course in the absence of any reasons being provided by HMRC, all the above can only be speculation.

10.58 Gift to charity by remittance basis taxpayer

A remittance basis taxpayer ("T") making a gift to charity should make the gift out of unremitted income (or foreign property qualifying for qualifying investment donation relief). The property should be received by the charity outside the UK. The charity may bring the assets to the UK without a remittance, provided the charity is not a relevant person in relation to T. A charitable trust will not be a relevant person (unless T has made an interest-free loan to it). A charitable company could be a relevant person if it is a close company.

CHAPTER ELEVEN

SAVINGS AND INVESTMENT INCOME

11.1 Savings and investment income – introduction

This chapter considers savings and investment income, dealt with in Part 4 ITTOIA (occasionally in Part 5).[1] I identify the charging provision for each type of income in this category and consider:

(1) When is a receipt "income" in nature and when is it capital?
(2) What is the source of the income?
(3) Where is the source?

These are distinct (though sometimes related) questions.

11.2 Why does "capital *v.* income" matter?

"Income tax is a tax on income." This slogan is less true now than when

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1 Section 3 ITA provides the basic outline:

3 Overview of charges to income tax

(1) Income tax is charged under—
  (a) Part 2 of ITEPA 2003 (employment income),
  (b) Part 9 of ITEPA 2003 (pension income),
  (c) Part 10 of ITEPA 2003 (social security income),
  (d) Part 2 of ITTOIA 2005 (trading income),
  (e) Part 3 of ITTOIA 2005 (property income),
  (f) Part 4 of ITTOIA 2005 (savings and investment income), and
  (g) Part 5 of ITTOIA 2005 (miscellaneous income).
(2) Income tax is also charged under other provisions, including—
  (a) Chapter 5 of Part 4 of FA 2004 (registered pension schemes: tax charges),
  (b) section 7 of F(No.2)A 2005 (social security pension lump sums),
  (c) Part 10 of this Act (special rules about charitable trusts etc), and
  (d) Chapter 2 of Part 12 of this Act (accrued income profits), and
  (e) Part 13 of this Act (tax avoidance).

it was formulated in 1900; but the question whether a receipt is "income" in the hands of the recipient remains important. References to "income" in tax legislation do not include capital receipts unless statute expressly so provides (which it often does).

The income/capital distinction is governed by case law. This issue arises often in the context of distributions from trusts and non-resident companies, where the income/capital distinction is fraught.

11.3 Why does source of income matter?

The identity of the source of income is important because different rules apply to income with different types of source. It is also necessary or helpful to seek to identify the source of income before one goes on to identify the location of the source.

It was originally the case that income tax was charged only on income from sources specified within the schedules, so in the absence of a source of income there could be no income tax. In *Colquhoun v Brooks* 2 TC 490 Lord Macnaghten said:

> "... the Act itself, in section 52, uses the expressions "sources chargeable under the Act" and "all the sources contained in the said several schedules" as describing everything in respect of which the tax is imposed.

This is no longer so. ITTOIA EN Vol II para 163 refers to this quote and provides:

> 1639. There were at that time [1889] no income tax charges on amounts treated as income. But the scope of Schedule D Cases IV and V has since been extended by provisions which charge to income tax, within one or other of the Cases, a profit or gain which would not otherwise be income arising from a security or from possessions within section 18(3) of ICTA. That is, on first principles it would be a capital profit or receipt. Such chargeable amounts could not therefore be said to derive from a "source" in the traditional sense. In *Walker v Centaur Clothes Group Ltd*, 72 TC 379, Lord Hoffmann commented (page 416):
>
>> Income tax is traditionally a source-based annual tax, liability depending upon the existence of a source of income falling under one of the Schedules during the year of assessment (see *Brown v National Provident Institution* 8 TC 57)....

> It is, however, no longer true to say that liability to income tax depends upon the existence during the year of assessment of a source within the charge. There are cases (such as post-cessation receipts) when liability depends upon the existence of income defined by reference to a source which does not exist within the year of assessment. Or liability may depend upon an event, such as a balancing charge on the sale of an asset which has attracted a capital allowance, or the receipt of a capital sum from a particular kind of transaction, which is deemed to be taxable income received in that year of assessment or sometimes spread over several years of assessment.

Nevertheless, in many cases the identification of the source of income remains important.

There is no statutory definition of "source". The word is too basic to be usefully defined. The word has been paraphrased as "origin"[2] and "chief" or "originating" cause[3] but these paraphrases are of no practical assistance. The concept of source is governed by case law.

11.4 Why does location of source matter?

The question of the location of a source of income is fundamental to the territorial scope of income tax. Section 368 ITTOIA provides:

> **368 Territorial scope of Part 4 charges**
> (1) Income arising to a UK resident is chargeable to tax under this Part whether or not it is from a source in the UK.
> (2) Income arising to a non-UK resident is chargeable to tax under this Part only if it is from a source in the UK. ...
> (4) This section is subject to any express or implied provision to the contrary in this Part (or elsewhere in the Income Tax Acts).

This is a statutory statement of a principle which was formerly in part in the statute and (where absent) was inferred by the courts.[4]

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2 *Hart v Sangster* 37 TC 231 at 235.

3 *IRC v Philips' Gloeilampenfabrieken* [1955] NZLR 868.

4 ITTOIA EN Vol II explains:

> "29. ...Since *Colquhoun v Brooks* 2 TC 490 the courts have followed Lord Herschell's judgment that (page 499):
>
> The Income Tax Acts, however, themselves impose a territorial limit,

Similarly, income must have a source outside the UK to qualify as RFI. Statute formerly used a variety of expressions[5] but now the standard terms are: "source in/outside the UK" or "income arising in/outside the UK".

Different considerations naturally apply to locating the source of different kinds of income.

In relation to income from intangible sources (such as shares, debts, trades), the law must somehow choose a connecting factor to link the source to a jurisdiction. In principle, it would not matter what the rule was, as long as there is some rule and its application is clear. There are many possible connecting factors, and the selection of the determining factor(s) must to some extent be arbitrary.

The IT rules for the location of an income source are different from the situs of asset rules for IHT/private international law.[6] It would aid clarity of thinking not to use the same word, situs, in both contexts, so in this book I prefer to use the term **"location"** of a source of income and keep *situs* for IHT/international law rules and CGT. But the usage of "situs" in an income tax context is too well established to alter easily, and no real difficulty ought to arise as long as one bears in mind that IHT/international law situs of assets, and IT location of source of income, are different concepts (though the rules often overlap.)

The location of a source is also important for double tax treaties.[7]

> either that from which the taxable income is derived must be situate in the UK or the person whose income is to be taxed must be resident there.

30. Whether Lord Herschell's words referred to the statutory rules of the time or to a general statement of the law, it is as the latter that they have been subsequently applied by the courts. For example in *Perry v Aston* 19 TC 255 Lord Russell of Killowen states (page 280):

> There must, of course, be the necessary limitation which is inherent in all our Income Tax legislation, namely, that what is taxed under or by virtue of this provision can only be either (1) income which is here, or (2) income of a person resident here.

31. Additionally there is the general principle of UK law that, unless the contrary intention appears, an enactment is taken as not applying to matters outside the UK."

5 e.g. in section 65 ICTA the test was whether a possession or security was "out of the UK", but that meant "having a source out of the UK"; see ITTOIA EN Vol II para 1642.

6 See 59.1 (Concept of situs).

7 See "Treaty Problems Relating to Source" [1998] BTR 222.

However DTTs sometimes lay down specific rules for locating a source (for treaty purposes) so it may be necessary to distinguish the concepts of domestic source location and treaty-source location.

11.4.1 *Location of source of income when there is no source*

It is noted above that sometimes income has no source, at least "in a traditional sense". ITTOIA EN was concerned about this:

> 1640. Although the definition [of RFI] uses "income which arises from a source" in respect of all income within the definition, specific rules have been added, in view of Lord Hoffmann's remarks [set out above], in sections 428(3) (deeply discounted securities) and 658(2) (beneficiaries' income from estates in administration), to attribute a foreign source to the income in question to ensure that there is no doubt that the definition applies to these provisions.

Section 368(3) ITTOIA provides:

> References in this section to income which is from a source in the UK include, in the case of any income which does not have a source, references to income which has a comparable connection to the UK.

ITTOIA EN Vol II expands on this:

> 34. However, while the term "source" may apply to the majority of receipts chargeable to income tax it does not apply to all such receipts. "Source" is something from which income arises and not all sums charged to income tax are by nature income. "Source" may not be the appropriate term where the amount charged to tax represents a profit on a transaction which is not by nature income and would not be charged to income tax without a specific charge. Indeed, the chargeable profit may arise on the disposal of an income source. This restricted meaning of "source" is supported by Lord Hoffmann's judgment in *Walker v Centaur Clothes Group Ltd*, 72 TC 379 and a more detailed discussion of this topic may be found in the commentary on Chapter 1 of Part 8 of this Act . [set out above]
> 35. It has therefore been necessary to consider how to express the territorial scope in cases where there is no natural source of income.
> 36. [Section 368(3)] is broadly worded to catch such income. Where the connection such income has to the UK is comparable to the

connection that income with a source in the UK has to the UK, then it is treated for the purposes of this section as income from a source in the UK.

11.5 Income from non-resident companies

Section 402 ITTOIA imposes a charge to tax on dividends from non-resident companies:

> (1) Income tax is charged on dividends of a non-UK resident company ...
> (4) In this Chapter "dividends" does not include dividends of a capital nature.

Non-dividend income from a company is caught by s.687 ITTOIA:

> **687 Charge to tax on income not otherwise charged**
> (1) Income tax is charged under this Chapter on income from any source that is not charged to income tax under or as a result of any other provision of this Act or any other Act. ...
> (4) The definition of "income" in s.878(1) does not apply for the purposes of this section.[8]

I refer to them together as dividends and non-dividend distributions. ITTOIA EN Vol. II explains why there are two charging sections:

> 184. Income which, under the source legislation, is charged to tax under Schedule D Cases IV or V, has, where appropriate, been fully integrated with the equivalent income arising from a UK source. In the case of dividends from non-UK resident companies there is no exact equivalent in terms of UK source income. The closest equivalent is the charge to tax on dividends and other distributions from UK resident companies (section 20 of ICTA, Schedule F in the source legislation). But there is no precise overlap. The UK charge, by the adoption of the definition of "distribution" from Part 6 of ICTA ... can include dividends or distributions of a capital nature and can also operate to convert payments that would otherwise be treated as interest into distributions.

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8 The disapplied definition states:
"'Income' includes amounts treated as income (whether expressly or by implication)."

> Any charge on distributions from non-UK resident companies must be confined to income only. For this reason ... it is not thought appropriate to integrate the charges. So a separate charge is needed to cover dividends from non-UK resident companies.
>
> 186. ... It is possible that a non-UK resident company may make a distribution of income which would not fall within Chapter 4 of Part 4 of this Act because it is not a "dividend". But if the distribution comprises income it will fall to be dealt with either under alternative specific charges (eg interest) or within "income not otherwise charged", the charge on which appears in Chapter 8 of Part 5 of this Act.

In practice it does not usually matter whether a receipt (to use a neutral term) is classified as a dividend (chargeable under s.402) or a non-dividend distribution (chargeable under s.687). In either case the receipt must be income and not capital in nature.

11.5.1 *"Dividend"*

ITTOIA EN provides:

> 187. The term "dividend" is not defined in this Act. "Dividend" is a widely used and understood term and is defined only in very specific circumstances not applicable in this context ... . It is not thought appropriate to attempt to define "dividend" here. It will usually be a matter of referring to the relevant company law to determine whether or not a payment made by a company is a dividend.

11.5.2 *"Distribution"*

What receipts from companies (other than dividends) are within the charge under s.687? For UK resident companies the charge is on "distributions" and the term is very elaborately defined. For non-resident companies, the charge is on "income" and there is no further guidance in the statute. But to be "income" there must be a distribution and the distribution must be of an income nature. Guidance can be found in company law cases in the context of rules prohibiting unauthorised distributions. In *Aveling Barford v Perion* [1989] BCLC 626, a company (Aveling Barford) sold an asset at an undervalue to another company (Perion). The sale was made at the direction of the shareholder of Aveling Barford, and Perion was held on

Jersey Trusts for the benefit of the shareholder and his family. Hoffmann J regarded this as a distribution (and so unlawful as the company had no distributable profits):

> The court looks at the substance rather than the outward appearance ... so it seems to me in this case that looking at the matter objectively, the sale to Perion was not a genuine exercise of the company's power in its memorandum to sell its assets. It was a sale at a gross undervalue for the purpose of enabling a profit to be realised by an entity controlled and put forward by its sole beneficial shareholder. This was as much a dressed-up distribution as the payment of excessive interest in *Ridge Securities* or excessive remuneration in *Halt Garage* ... The fact that the distribution was to Perion rather than to Dr. Lee or his other entities which actually held the shares in Aveling Barford is in my judgment irrelevant.

The decision is criticised in Bramwell *et al*, *Taxation of Companies and Company Reconstructions*, para B2.2.7 but it has been consistently followed and should be taken to represent the law.[9]

When the asset distributed is a non-cash asset, there has been some debate whether the amount of the distribution is computed by reference to the market value or the book value of the asset. For UK company law purposes, one takes the book value: s.845 Companies Act 2006. But for tax purposes, one should take the market value.

11.5.3 *Distribution to non-shareholder*

Aveling Barford shows that a distribution to a non-member at the direction of shareholders is still a distribution for the purposes of company law rules regulating distributions. How does one reconcile this with section 829 CA 2006 which defines "distribution" to mean:

> Every description of distribution of a company's assets *to its members*...

There are two answers. The word "to" may be read as "to or at the direction of". Alternatively it might be said that there are two sets of rules

9 See *MacPherson v European Strategic Business Bureau* [2000] 2 BCLC 683 and *Clydebank Football Club v Steedman* [2002] SLT 109 at [75].

relating to distributions from companies, the statutory rules and common law rules, and a distribution to a non-shareholder is a "distribution" for the purposes of the latter. It would not matter for company law which of these is correct.

What is the tax position on a distribution to a non-shareholder? If the company is owned by A, an individual, and the company makes a distribution to B, then B cannot be subject to income tax as he has no source of income. A will be chargeable to tax on the distribution if he is a person receiving or entitled to the income: see s.689 ITTOIA.

What if the company is owned by a discretionary trust, and the company makes a distribution to B, a beneficiary? There are several possible solutions:

(1) The distribution is income of B in the form of a company distribution.
(2) The distribution is income of B in the form of a trust distribution.
(3) The distribution is:
  (a) income of the trustees in the form of a company distribution; and
  (b) income of B in the form of a trust distribution.
(4) The payment is not income of B or of the trustees.

Solution (1) seems sensible but is inconsistent with the source doctrine which states that one cannot receive income (for tax purposes) unless one has a source of income: B has no interest in the company. (B's interest in the discretionary trust is not an interest in the company.) A radical House of Lords could (and perhaps should) reform the source doctrine to reach this result, but subject to that, solution (1) is not available.

It is considered that solution (2) is to be preferred. The reason that B receives the distribution is that he is a beneficiary of the trust, so the result is like any other trust distribution of an income nature.

Appropriate documentation would of course bring the matter into class (3) but in the absence of a payment to the trustees, it is artificial to regard them as in receipt of income.

Solution (4) is arguable but a court may regard it as too good to be true.

In these cases IHT needs to be considered: see ss.94, 99 IHTA. Likewise CGT, particularly if B is UK domiciled: see ss.22, 30, 122 TCGA. Lastly, s.682 ITA (transactions in securities) may also need to be considered.

11.6 Distribution from a non-resident company: income or capital?

In this context the income/capital distinction is one of the general law (e.g. it applies for trust law purposes) which is adopted by UK tax law. Hence many of the cases are trust cases and not tax cases.[10]

11.6.1 *The general principle*

Courtaulds Investments v Fleming 46 TC 111, at p.124 summarises the law as follows:

> The rights and interests of shareholders in the assets and the profits of companies in which they hold shares vary widely in detail, but I think they can all be said to fall under three heads:
> (1) rights to participate in the distributable profits of the company while it is a going concern;
> (2) rights to participate in the division of the assets of the company in a liquidation, and
> (3) rights to participate in any distribution to shareholders on an actual or notional reduction of capital.
> Anything received under the first head is treated by English law as income of the recipients for both tax purposes and trust purposes (but subject as to the latter to any special provision of the trust) notwithstanding that the source of the distribution may be a profit not of the company's business but on capital account: see *In re Doughty* [1947] Ch 263 and *IRC v Reid's Trustees* 30 TC 431. Anything received under the second head is treated by English law as capital both for tax purposes and, subject as aforesaid, for trust purposes. So also is anything received under the third head. That this is so for trust purposes is clear from *In re Duff's Settlements* [1951] Ch 923, where moneys received by trustees on a distribution of part of a share premium account under the Companies Act 1948, s.56, were held to be capital for the purposes of their trust. My attention was not drawn to any case where the same has been held to be so for tax purposes on a distribution of a share premium account under s.56, but in my judgment that must follow.

10 See Law Commission Consultation Paper 175 (Capital and Income in Trusts, 2004) accessible *www.lawcom.gov.uk*; and Stephen Brandon QC's *Taxation of Non-UK Resident Companies and their Shareholders* (Key Haven Publications, 2002) para 2.2.

The HMRC view was set out in the Inspectors Manual. The material was deleted from the current SAI Manual, which deals with the question very briefly at 5210. I set out the old Inspectors Manual passages, as they will no doubt continue to reflect HMRC practice:

> **1610. Distributions/foreign cos: In cash**
> Published: 9/95
> ... a cash distribution to its shareholders by a foreign company will normally be assessable under Case V, whether it is attributable to the undivided[11] profits or to the capital resources of the company (*IRC v Trustee of Joseph Reid* 30 TC 431). Where, however, cash —
> a) is distributed on the liquidation of the company (*IRC v Burrell* 9 TC 27) or
> b) comprises a return of part of the shareholder's capital interest in the company (*Rae v Lazard Investment Co* 41 TC 1; *Courtaulds Investments v Fleming* 46 TC 111),
>
> the cash constitutes a capital sum not assessable as income under Case V. ...

This is correct, though (b) is a slightly abbreviated summary of the position as more fully set out in *Courtaulds Investments*.

> **1613. Distributions/foreign cos: Not in cash: Release of assets**
> Published: 9/95
> Where a foreign company releases[12] some of its assets (for example, shares it holds in another company) to its shareholders, the distribution will normally be assessable under Case V by reference to the UK currency value of such assets at the date of distribution (*Pool v Guardian Investment Trust* 8 TC 167; *Wilkinson v IRC* 16 TC 52; *Briggs v IRC* 17 TC 11). Where, however, the assets are released on liquidation or are otherwise claimed to be a return of capital to the shareholder, the claim should be referred to Revenue Policy, International (Cases IV and V), Victory House in accordance with IM1610, last sub-para.

11 [Author's Note] "Undivided" in this context is an old-fashioned term for "undistributed".

12 [Author's Note] "Releases" here simply means "transfers". The word "release" was used in *Pool v Guardian* (1922), but is not normally used nowadays in this sense.

The Manual considered separately:

(1) distributions of cash; and
(2) distributions of non-cash assets of the company

but the principle is exactly the same.

11.6.2 *Stock option*

The Inspectors Manual continued:

> **1611. Distributions/foreign cos: Not in cash: Option cases**
> Published: 9/95
> Where a foreign company declares a cash dividend but offers its shareholders, on their own initiative, the option of taking up further shares in lieu of the cash dividend, a shareholder who exercises the option to take up the shares is not assessable under Case V of Schedule D in respect of that dividend. If, however, a shareholder does not exercise the option but takes the dividend in cash, he is assessable under Case V of Schedule D on the amount of the cash dividend. See CG51823 regarding the capital gains position.

11.6.3 *Issue of shares or debentures*

The Inspectors Manual continued:

> **1612. Distributions/foreign cos: Not in cash**
> Published: 9/95
> Where a foreign company capitalises undivided [i.e. undistributed] profits and —
> a) issues to its shareholders the additional capital so created, in the form of its own shares or debentures, in proportion to the number of shares already held by them or
> b) satisfies a dividend out of such profits by the issue of its own stocks or shares (for example, a "stock dividend" by a United States company),
>
> such a distribution does not constitute income for Case V purposes in the hands of the shareholder. This principle applies when the distribution is actually made in shares, whether or not an effective option was given to the shareholder to receive cash in place of shares (*IRC v Blott*, 8 TC 101; *Whitmore v IRC* 10 TC 645; *IRC v Fisher's*

Executors, 10 TC 302; *IRC v Wright* 11 TC 181). ...
In cases where the distribution is not actually made in shares and the shareholder accepts cash from the company under an option given to him to receive cash in place of shares, the cash is assessable as income in accordance with IM1610.

1614. Distributions/foreign cos: Certificates of indebtedness
Published: 9/95
As regards liability in respect of dividends received in the form of certificates of indebtedness redeemable at a future date, see *Associated Insulation Products Ltd v Golder* 26 TC 231.
See also IM4580 as regards liability on the sale or transfer of such certificates.

11.6.4 *Dividend re-investment plans*

The Inspectors Manual continued:

1615. Dividend reinvestment plans
Published: 9/95
Some foreign companies, particularly in North America and Australia, establish dividend reinvestment plans for their shareholders. Such plans can be structured in a number of different ways, some of which result in liability under Case V when a dividend is declared, and others which do not. At one extreme is the pure bonus issue, when a dividend is declared payable in shares with no option for the shareholder to take cash. Alternatively a company may arrange for cash dividends to be paid to a third party, typically a bank, which then applies the dividends in the purchase of additional company shares in the market on behalf of the shareholder. The first situation falls within the principle of *IRC v Blott* (8 TC 107) – see IM1612. The second gives rise to a Case V charge because the reinvestment in the company is regarded as a voluntary application of income which has already arisen to the shareholder.
Between these two extremes lies a variety of situations, each of which must be considered by reference to their own facts to determine whether a Case V charge arises. Where there is any doubt as to whether the receipt of shares under the terms of a dividend reinvestment plan gives rise to a Case V charge, refer the taxpayer's file, together with a copy of the plan prospectus, to Revenue Policy, International (Cases IV and V) Victory House.

11.7 Income distribution from company: location of source

If a distribution from a company is income in nature, the question arises as to where is its source.

The House of Lords held in *Bradbury v English Sewing Cotton Co* 8 TC 481 that the source of income from shares is situated in the place where the company is resident – not where it is incorporated or where the share register is kept. (This is in stark contrast to the IHT/private international law situs rules.) This rule is now statutory: s.383 ITTOIA imposes tax on distributions from UK resident companies.

11.8 Building societies

In practice, income from a building society will have a UK source. ITTOIA EN Vol II explains:

> 48. Under section 66 FA 1988 a society incorporated under the Building Societies Act 1986 will be resident in the UK through incorporation. As long as dividends are paid by a UK resident company they have a UK source under the principle in *Bradbury v The English Sewing Cotton Company Ltd* 8 TC 481.
>
> 49. But a society may be non-resident where it satisfies a residence test in the territory of a treaty partner and the treaty awards residence to that other territory. Section 249 FA 1994 will then apply to treat the society as non-resident. Theoretically dividends paid by a building society may therefore arise from a source outside the UK. This would be most unlikely, however, since a building society may only be incorporated under the Building Societies Act 1986 if its principal office is in the UK. With the place of incorporation and the principal office in the UK a residence test is unlikely to be satisfied in another territory.

11.9 Open-ended investment companies and AUTs

ITTOIA EN Vol II discusses the location of the source of OEIC income:

> 50. The definition of an open-ended investment company in section 468(10)ICTA carries a limitation that the company should be incorporated in the UK under the OEIC regulations of 1996. Section 468(10) ICTA is inserted in section 468 of ICTA by para 10(4) (Open-ended Investment Companies (Tax) Regulations 1997 SI 1997/1154). All open-ended investment companies within the definition in section 468(10) ICTA are therefore subject to the company residence rule in section 66 FA 1988 ("regarded for the purposes of the Taxes

> Acts as resident”). Open-ended investment company interest distributions treated as made by a UK resident company will be UK source income. Section 249 FA 1994 could in theory also apply to make such companies non-resident (as explained in connection with industrial and provident societies). In that case interest distributions made will be treated as dividends from non-resident companies.

For AUTs see 27.2 (Income accruing to unit trust).

11.10 Industrial and provident societies

ITTOIA EN Vol 2 explains the source of income from an industrial and provident society:

> 52. Under section 66 of FA 1988 a society registered under the Industrial and Provident Societies Acts will be resident in the UK through incorporation. A society may, however, be non-resident where it also satisfies a residence test in the territory of a treaty partner of the UK and the treaty awards residence to that other territory. Section 249 of FA 1994 will then apply to treat the society as non-resident.
> 53. Section 486(4) of ICTA provides that share or loan interest is chargeable under Schedule D Case III. Theoretically therefore payments by a registered society may arise outside the UK but be charged under Schedule D Case III and not able to benefit from treatment specific to Schedule D Cases IV and V. For the sake of consistency this section[13] treats such income arising outside the UK as relevant foreign income and therefore able to benefit from the special rules in Part 8 of this Act.

11.11 Interest: charge and location of source

Section 369(1) ITTOIA imposes the charge on interest:

> Income tax is charged on interest.

I refer to the person paying interest as “**the debtor**” and the recipient as “**the creditor**”.

Foreign source interest is outside the scope of withholding tax[14] and only

13 [Author’s Note] See ss.379 and 83D(2) ITTOIA.

14 See 29.1 (Withholding tax on interest).

taxed (if at all) as RFI so the question of source matters to both creditor and debtor.

The statute gives virtually no guidance on the location of a source of interest, so one falls back on principle, case law and HMRC guidance.

Principle cannot identify the "right" connecting factor(s) but it can identify some approaches to the issue as unsatisfactory.

The location needs to be known by the debtor (who may have to deduct tax at source) and creditor (who may be taxable on the interest). This suggests no weight should be given to factors not likely to be known by both parties.

Factors which the parties can easily manipulate without commercial cost or inconvenience are not suitable (at least from HMRC's viewpoint and one can expect the courts to sympathise).

Debts are frequently assigned, and it is suggested that:

(1) assignment should not alter the location of the source; and
(2) facts not likely to be known by an assignee should not affect the location.

Many of the connecting factors may change, and it is possible that the source of interest can change its location. However, it would not be convenient for location of a source to change very often. There are two ways to deal with this:

(1) to place little or no weight on features which may easily change; or
(2) to look at the situation at the time the debt arises, and to ignore later changes.

Solution (1) seems preferable.

There are many possible connecting factors. The following is not a complete list but it includes the main factors:

(1) the debtor:
    (a) residence of debtor;
    (b) place of business of debtor; [15]
(2) payment of the interest:

15 Place of incorporation is another conceivable connecting factor but no-one has ever suggested it should be relevant.

(a) place where interest is paid;
(b) situs of funds out of which interest is paid;[16]

(3) contract under which interest is paid:
(a) proper law;
(b) place where contract would be enforced;
(c) place where contract is made;
(4) situs of debt on which interest is due under IHT/international law principles (i.e. location of deed if debt is a specialty);
(5) place where debtor uses the money borrowed (e.g. to purchase UK/non-UK situate asset);
(6) place where money is lent or where credit is provided;
(7) situs of security for debt (if any);
(8) residence of guarantor (if any);
(9) residence of creditor.

I shall evaluate these factors in order.

11.11.1 *Residence and place of business of debtor*

Residence of the debtor is in principle a satisfactory connecting factor. In the case of dual resident debtors, the place of business connected with the loan would usually act as a suitable tie-breaker.[17]

A difficulty arises if the debtor changes his residence, which if not common is by no means impossible. This was pointed out in *Philips*.[18] But a solution might be to ignore subsequent changes of residence. Similarly, if a debtor dies and the liability is that of PRs, the place of residence of the PRs should not affect the source of the interest.

16 This is often called the "source" of the payment but it is hopelessly confusing to use the word "source" in that way.

17 See 59.10.2 (Dual resident debtor).

18 See 11.12.4 (*IRC v Philips' Gloeilampenfabrieken)* [1955] NZLR at p.898: "In my opinion, the fallacy in the able argument presented by [counsel for the Commissioner] was exposed when he felt obliged to submit (as indeed he was if he was to be consistent) that if a New Zealand citizen, while in London, found himself in financial difficulties and had to obtain from a London money-lender a loan, which he was able to repay over a period of years only after he had returned to his own country, the London money-lender could be assessed with [New Zealand] income tax ..."

11.11.2 *Payment of the interest (place where interest is paid or situs of funds out of which interest is paid)*

This is not a suitable connecting factor as it is easily changeable. This view is supported by *IRC v Philips*' *Gloeilampenfabrieken*:

> It is not sufficient to ascertain the fund out of which the income was in fact paid, which is no more than the reservoir from which it was drawn. It is not whence it was paid, but why it was paid, that is the determining factor. The emphasis is not upon the receipt, but upon the derivation of the income. Consequently, it does not constitute the source within the meaning of the section that the money [used to pay the interest] was drawn from or provided by the trading profits in New Zealand. The New Zealand company [the debtor] was free to obtain the funds with which to perform its obligation anywhere it chose, from deposits in England, if it had any, or from borrowing in England, or from the profits of its trading in New Zealand. That was a domestic matter. The money could "come from" any of these "sources", but none of them would be the source from which the [creditor] derived what it received as income.[19]

In other words, one should not equate the location source of the interest with the situs of the *resources* that the debtor uses to pay the interest.[20]

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19 See 11.12.4 (*IRC v Philips' Gloeilampenfabrieken*) [1955] NZLR at p.898.

20 For completeness, I should mention *IRC v Broome* 19 TC 667, where the features of the loan were as follows:
(1) (a) The debtor was (primarily) resident in Kenya (also UK resident, but that does not matter).
(b) However, the original debtor died. His executors were UK resident.
(2) The executors [debtors] paid the interest in the UK out of funds in the UK.
(3) The loan was enforceable in Kenya.
(4) The creditor was resident in Kenya.
Finley J held:
"There is no doubt at all that if a payment is made by a person here out of a source which is here, then that payment attracts tax. ... I think it was payment out of a source here. The first two payments are perhaps a little more clear, because there the payment was actually made to Earl Kitchener [the creditor] personally in this country. He happened to be here; he was resident abroad, but he happened to be here, and he was actually paid by the executors in London; and equally [the other payments] were made in London, were sent to a bank in London, and were remitted by the bank in London to Kenya to be paid there. In these circumstances I am of opinion that this was a payment made by persons resident in London out of sources

11.11.3 *Contract under which interest is paid: (a) proper law, (b) place where contract would be enforced, (c) place where contract is made*

These are not suitable connecting factors as they are within the control of the parties.[21]

11.11.4 *Situs of debt: location of deed if debt is a specialty*

For IHT/international law the situs of a specialty debt is the location of the deed.[22] This is obviously an unsuitable connecting factor. The debtor will not have possession of the deed and may not know its location. The location is easily changeable, and the rule would allow easy tax planning.

This view is supported by *IRC v Philips' Gloeilampenfabrieken*:

> If the location of the debt were to be selected as the test, the source would be located differently according as whether the contract was a simple contract or a specialty; and, in the latter case, its location would arbitrarily change with the actual situation of the deed itself. Such a test would, indeed, be far from the practical commonsense test prescribed by the authorities; and I cannot think it proper to apply it here if some other is available.[23]

The High Court of Australia rejected the same argument for similar reasons in *Studebaker Corporation of Australasia v Commissioner of Taxation for New South Wales*.[24]

My view could also obtain support from *Bank of Greece*[25] where

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in London."

This passage adopts uncritically the view criticised here that the funds used to pay interest determine the source of interest. It is suggested that no guidance should be taken from *Broome* and it has (rightly) been ignored in all later cases.

21 Place of enforceability is also unsuitable as a contract may be enforceable in more than one place, or the place of enforceability may be unclear.
The place the contract is made is also unsuitable because the place the contract is made is itself often difficult to identify. See 14.16 (Where is contract made).

22 See 59.11 (Specialty obligation).

23 See 11.12.4 (*IRC v Philips' Gloeilampenfabrieken*) [1955] NZLR at p.898.

24 See 11.12.4 (*IRC v Philips' Gloeilampenfabrieken*).

25 See 11.12.1 (*Bank of Greece*).

although the court did not seriously address the question of the location of a source of interest, its approach was certainly not consistent with the IHT/international law approach.

For a simple debt, the IHT/international law approach takes us back to residence as a connecting factor, which is discussed above.

It is not illogical or inconsistent to say that the situs of a debt for IHT/international law purposes is in one country but the location of the source of interest on that debt for income tax purposes is in another. One might simply say that the two taxes apply different rules. This is the case for shares, which may be non UK situate for IHT/international law but whose dividends may be UK source (if the company is UK resident.) Alternatively, and more subtly, one might say that the source of interest (for IT purposes) is not the debt but the transaction which gives rise to the debt (which may be located in a different place from the location of the debt).[26] Either way, the IHT/international law situs rule is not determinative.

I stress this as the view that the location of the source of interest for IT should be equated with IHT/international law situs of the debt has from time to time found support.[27]

11.11.5 *Purpose for which the loan is made*

This is not such a suitable connecting factor, for it will often not be possible to identify a purpose with any particular location. Also money borrowed for one purpose may later be used for another.

11.11.6 *Place where money is lent (where money is received)*

This is a sensible connecting factor. It may be objected that it allows tax planning where money is lent in one jurisdiction and then immediately transferred to another. But the courts could easily look through transient arrangements of that kind to identify the place where the money is substantially received.

26 *Philips* takes this approach:
27 See 11.12.2 (*Hafton Properties*); 11.13.1 (HMRC view before 1979).

11.11.7 *Situs of security for debt*

A rule that source of interest on a secured debt depends on the location of the property on which the debt is secured is not sensible or workable, for the following reasons:

(1) A debt may be charged on property in two different countries.
(2) The rule becomes absurd if a large debt is secured on an asset of a small value. Would one say that a £100 million debt is situate in Jersey if it is secured on property there worth £100,000? Also, one cannot have a rule where the location of interest depends on the relative value of the debt or the security, which may fluctuate from time to time (though that might be resolved by looking only at the position at the time the debt arises.)
(3) If land determines the location of interest from of a debt secured on land, then a debt charged on (say) shares should be situate where the shares are situate.

This rule would sometimes allow scope for tax planning.

11.11.8 *Residence of guarantor (if any)*

No weight should be given to the residence of a guarantor, since in the normal course of events a guarantor would not be called on to make any payment.

11.11.9 *Residence of creditor*

No weight should be given to the residence of the creditor, since one is looking for the source and not the destination of the interest; also this may change easily as debts are usually assignable and frequently assigned. A single debt may be owed to two creditors resident in different places, but the interest on that debt cannot have two different sources.

11.11.10 *Unsatisfactory approaches*

The most unsatisfactory approach of all is to say that it is a question of fact.[28] The meaning of "source" is a question of law and so is the question of whether known facts (which will usually be simple) fall within that meaning. It is the task of the courts to provide an answer to that question.

Equally unsatisfactory is to say that the answer is whatever a "practical man would regard as the real source". The only way in which a man, practical or otherwise, can identify a source of interest (other than tossing a coin) is to apply a theory as to the priority of rival connecting factors.[29]

The exhortation to adopt a "practical approach" is harmless but not particularly helpful. No-one advocates that the court should adopt an impractical approach. But those who stress this approach should bear in mind that the one thing that a practical man will demand of the law is that it will provide a clear *answer* to the question of where is a source. There is nothing more impractical than uncertainty. What Kurt Lewin said of psychology is also true of tax: there is nothing so practical as a good theory.

It is not satisfactory to say that all the features listed are relevant, and if different features point in different ways, it is a matter of carrying out a balancing exercise. We need guidance on which factor has priority or there is no law on the subject at all. The formulation derives from Commonwealth cases on the source of *trading* income.[30] There it seems more apt as the circumstances in which trading income arises differ very widely indeed. But even in that context experience has shown that it has not worked well, because no consistent pattern has developed as to which

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28 Sometimes a "practical hard" matter of fact, the phrase derives from *Nathan v Federal Commissioner of Taxation* [1918] HCA 45; (1918) 25 CLR 183 and is also mentioned in *Rhodesia Metals v CT* [1940] AC 774 at p.789, but the adjectives are meaningless. The point is made more discreetly by Lockhart J at first instance in *Spotless* ("... a little opaque...")

29 Contrast Keynes' *dictum* that "practical men who believe themselves exempt from intellectual influence are the slaves of some defunct economist". See 11.12.4 (*IRC v Philips' Gloeilampenfabrieken*) [1955] NZLR 868 at pp.895–6: "What sort of thing is to be looked for when it is sought to discover a *source of income*? This is a question less simple than it seems at first sight, and its difficulty does not seem to me to be greatly lessened by taking the 'practical' approach to it first put forward in *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183. ... I am attracted by an approach by which an attempt is made to state lucidly what must be meant by the word 'source' in the phrase 'source of income' in given circumstances."

30 *Rhodesia Metals v CT* [1940] AC 774.

factors have the greatest weight.[31] However that may be, the questions of the source of *interest* and the source of *trading* income are entirely different. There is no reason why the test should be the same. The point is made correctly in *Philips*:

> The location of the source of profits of a business, for instance furnishes a kind of investigation quite different from that of the source of interest on moneys lent, and decisions on sources of one kind of income may be of little assistance when considering sources of a different kind of income.[32]

11.12 Case law on source of interest

The case law is not easy reading.

11.12.1 *Bank of Greece*

The facts of *Bank of Greece*[33] are a little complicated and unusual, and one needs to understand them in order to see clearly what the case is about. The facts are not very fully stated by the House of Lords but further details can be teased out from the various reported cases concerning these much litigated bonds.

The case concerned bearer bonds issued by a Greek bank in 1927. The bonds suffered various changes in the turbulent years which followed. The bonds had the following features (using the numbering of the list in the above paragraph):

(1) The debtor was non-resident (a Greek bank.).
(2) (a) Payment was to be made in sterling.[34] Payment was to be made in London or (at the option of the creditor) in Athens, by cheque on London.
    (b) Payment would in the ordinary course have ultimately derived

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31 See 14.3 (Non-resident trader rules).

32 See 11.12.4 (*IRC v Philips' Gloeilampenfabrieken*) [1955] NZLR 868 at p.896.

33 *Westminster Bank Executor and Trustee Company (Channel Islands) v National Bank of Greece* 46 TC 472.

34 For completeness, in 1935 this changed so that Greek residents could only be paid in drachmae: see [1958] AC 509 at p.510 but nothing turned on that.

from funds situate in Greece.[35]

(3) The bonds were governed by English law and were enforceable in England.[36] (Enforceablility was originally recognised in Greece, but that ceased to be the case following a moratorium under Greek law, raising conflict of law issues which twice went to the House of Lords.)
(7) The debt was originally secured by lands in Greece but these properties were taken over or disappeared following the German occupation of Greece in 1941.[37]
(8) The guarantor was non-resident.

It is fairly clear (and all sides accepted) that the interest on the bond originally had a Greek source. Almost[38] all the features of the debt pointed the same way, to Greece. The House of Lords held that the interest had a foreign source in these words:

> [1] the bond itself is a foreign document, and
> [2] the obligations to pay principal and interest to which the bond gives rise were obligations whose source is to be found in this document.

This was adequate for the decision as it related to a point not in dispute. However, the *dictum* is inadequate as a basis for ascertaining the location of a source of interest in other cases. The court did not say how it reached its conclusion: it just described the loan and stated the conclusion.

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35 I think this is what Lord Hailsham means in the somewhat convoluted sentence at p.494A.

36 [1958] AC 509.

37 46TC 472 at p.483H.
At p.493H Lord Hailsham says that the debt was secured by lands *and public revenues* in Greece, As far as I can tell from the case reports this seems to be a slip, or perhaps Lord Hailsham was referring to the income of the bank as "public revenues" as the National Bank of Greece was publically owned. Nothing turns on that point but it is important to note that the bonds were bank bonds and not government bonds.

38 The following features in *Bank of Greece* did not cause it to have a UK source:
(1) payment made in sterling
(2) English proper law
(3) interest paid in England.
(4) Karminski LJ adds that "the loan was raised in London": 46 TC at p.489.

The conclusion that some have drawn from this case is that all the features listed in the list above were relevant, and if different features point in different ways, it is a matter of carrying out a balancing exercise (how one goes about that is not explained). In my opinion this is a complete misreading. *Bank of Greece* provides no support for that approach whatsoever. The speech in the case had no need to say anything about the location of source of interest paid by the principal debtor, because that location was not in dispute. The court heard no argument about the principles of identifying the location of the source of interest. The relevant cases were not cited. In my view *Bank of Greece* gives no guidance at all on what is the test for the location of the source of interest. The fragment of the sentence ("the bond is a foreign document") was merely descriptive of the facts of the case and not intended to lay down a general test for location of a source of interest. If it lays down a test at all, it is imponderable. In a marginal case, how does one decide if a bond is a foreign document? The test can only be applicable to interest on securities represented by bonds.

The actual dispute in *Bank of Greece* concerned the location of the source of income consisting of guarantee payments. The original borrower, the principal debtor, (the National Mortgage Bank of Greece) had defaulted on the bond and the payments were made by the guarantor. (To be precise, the payments were made by a company which had succeeded to the guarantor following an amalgamation, and which was subject to the same obligations as the original guarantor, but that made no difference.)

It was not completely clear that guarantee payments were to be classified as "interest".[39] However if they were not interest they were income in the category of annual payments, and it is sensible that location of the source of such payments should be determined on principles similar to those which apply to interest, so that makes no difference.

Why was it argued the income had a UK source?

> The only circumstances relied on by the Appellants as supporting their contention that the obligation was located inside the UK were as follows.

39 Two of the three judges in the CA held that the payments were interest, and in the House of Lords this was said to be "attractive". But nothing turned on this point.

[1] Although the original guarantor had no branch in the UK, the present Appellants had acquired one on their universal succession in London.[40]
[2] Moreover, it was argued that, since discharge of the obligations under the bond in Greece had been caught by the moratorium enacted by the Greek Government, it followed that the only place at which the obligation of the guarantor could have been discharged or enforced was in London.[41]

There is some strength in this argument but it did not win the day. These changes did not affect the location of the source of income:

> Speaking for myself, I do not see how an obligation originally situated in Greece for the purposes of British income tax could change its location either by reason of the fact that
> [1] one guarantor had been substituted for another, or ...
> [2] the second guarantor so substituted subsequently acquired a London place of business, or ...
> [3] the Government of Greece had by retrospective legislation altered by moratorium and substitution of a new guarantor for the purposes of Greek law the obligations imposed upon the principal debtor and the guarantor.
> The Appellants acquired no obligation different from that of the original guarantors, and that was the obligation imposed on the original guarantors by the terms of the bonds.[42]

Bank of Greece is authority for the (sensible) proposition that sources of interest are fixed and do not move with changes of circumstances of the debt.[43] It is not relevant to any other aspect of the location of a source of interest.

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40 Lord Hailsham means that the guarantors who succeeded to the original guarantor acquired a branch in London on their succession to the original guarantor.

41 46 TC at p.494.

42 46 TC at p.494.

43 More accurately, the case is authority for the proposition that the changes which occurred in the *Bank of Greece* case did not change the location of the source. It is open to a court to distinguish that from other types of changes. However the changes which occurred there were so fundamental that it is considered that there will be few if any cases where the location of a source of interest will move.

11.12.2 *Hafton Properties*

In *Hafton Properties v McHugh* 59 TC 420 (a decision at Special Commissioner level) the facts were weighted as strongly as possible in favour of a foreign source, except there was a UK resident debtor. Under the original loan agreement, a US company borrowed from a US bank, the loan being secured on US property. Hafton (UK resident) acquired the property subject to the mortgage. It paid interest. This was not UK source:

> [1] In one respect the Greek Bank case is different from this one, in that in that case the debtors (both original and substituted) were at all times essentially Greek in character. Nevertheless I collect from Lord Hailsham's speech a clear disinclination to regard sources of income as being peripatetic. He looked to the nationality (if I may so put it) of the document creating the obligation, and, applying the sentence which I have already read from that speech to the present case, there can be no doubt that the obligation here was American in character.
> [2] That is fortified, of course, by the fact that the debt was a mortgage debt. Such a debt is regarded for private international law purposes (at any rate) as a speciality debt, the situs of which is to be found where the mortgage deed is to be found. The mortgage deed is, and so far as I know always has been, in the United States.[44]

Point [1] is right. If a change of guarantor does not affect location of a source of interest, neither should a change to the identity of the principal debtor. This point will not often arise because the facts of *Hafton Properties* (purchase of property subject to mortgage) are unusual. A mortgage is usually paid off at the time of the purchase.

A more common situation is that an individual who has borrowed funds later comes to the UK and continues to pay interest. *Hafton* supports the view that (whatever the test for location) the interest does not become UK source merely because the debtor becomes UK resident. Conversely does interest cease to be UK source just because a debtor becomes non-resident.

Point [2] is therefore *obiter*; it is considered that situs of the debt on IHT/international law principles should not carry much if any weight, for

44 59 TC at p.426.

the reasons given above.

11.12.3 *Hong Kong cases and practice*

Thus there is no UK case giving any significant guidance. There are some Commonwealth cases.

In *IRC v Hang Seng Bank* [1990] STC 733 at p.740 the Privy Council state the position quite clearly:

> If the profit was earned by ... lending money ... the profit will have arisen in or derived from the place where ... the money was lent ...

In *IRC v Orion Caribbean* [1997] STC 923 at p.930 the same court made (I think) the same point, but more cautiously:

> If [a company] lent its own money to a borrower in, say, New York,[45] then other things being equal there might be little difficulty in saying that the location of the source of the interest on the loan was New York.

Both these cases were trading cases, i.e. the issue was the source of trading income. Since different principles apply to trades[46] the comments are *obiter*. However, there is much to be said for the *Hang Seng* approach and it represents the generally held view in Hong Kong. The Hong Kong Revenue explain:[47]

> 2. Only interest arising in or derived from Hong Kong is liable to profits tax. For many years, the Department has taken the view that for the purpose of determining the place where interest arises or is derived from, it is the location of the originating cause that almost invariably determines the source. In essence, the place of derivation of interest is the place where the credit was provided to the borrower, i.e. *the place where the funds from which the interest is derived were provided to the borrower*, commonly known as the "provision of credit" test. This view is based on the decisions in *IRC v Philips Gloeilampenfabrieken,* and

45 I assume this means that the money was lent (received) in New York.

46 See 11.11.10 (Unsatisfactory approaches).

47 Departmental Interpretation and Practice Notes No. 13 (Revised) Profits Tax: Taxation of Interest Received, December 2004, accessible *www.ird.gov.hk/eng/pdf/e_dipn13.pdf*.

IRC v Lever Brothers & Unilever.[48]
3. If the originating cause is situated in Hong Kong, the source of the interest is in Hong Kong, irrespective of the currency in which the loan is denominated, the place of residence of the debtor or the place where the debtor employs the capital.[49]

11.12.4 *IRC v Philips' Gloeilampenfabrieken*

I have already mentioned *IRC v Philips' Gloeilampenfabrieken ("Philips")*.[50] This decision of the Court of Appeal of New Zealand carefully considers and cogently rejects various alternative tests of source, including the location of funds used to pay the interest and

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48 For these two decisions see 11.12.4 (IRC v Philips' Gloeilampenfabrieken).

49 Emphasis added. The statement continues with three exceptional cases:

"[1] Whilst the emphasis is generally placed on the provision of the credit, in some situations, such as mortgages, the originating cause may well be the mortgage itself.

[2] In addition, interest has a Hong Kong source where it forms an integral part of a trading transaction carried out in Hong Kong, e.g. where a Hong Kong manufacturer sells his goods to an overseas buyer on extended credit terms. In such situations, the interest is just as much a part of the profit as the trading profit itself and also arises in Hong Kong, e.g. BR 20/75, IRBRD, vol. 1, 184 and *Studebaker Corporation of Australasia v C of T,* 29 CLR 225.

[3] It should also be noted that the "provision of credit test" is not applicable where the loans are not simple loans of money. The Privy Council held in the case of *IRC v Orion Caribbean* 4 HKTC 432 [1997] STC 923 that where the taxpayer earned its profits by borrowing and lending of money, the proper test to determine the source of the profits was the operation test, i.e. "one looks to see what the taxpayer has done to earn the profit in question and where he has done it". In the case of a money lending business, the taxpayer's business would normally encompass a broader range of activity, including the borrowing and/or lending of money. For this type of business, the Department will apply the operation test instead of the provision of credit test in determining the source of the interest income."

Cases [2] and [3] are both trading cases and not governed by the location test for interest.

Whether case [1] should be an exception is more doubtful, though it has a little support from *obiter* in *Philips* at p.898: "Where the debt is a secured one, it is possible that the application of the practical test may, in some cases, make it arguable that the source is where the security is; or where the registry is wherein the mortgage deed is registered..."

50 10 ATD 435 [1955] NZLR 868 accessible *www.kessler.co.uk*.

IHT/international law situs rules. It concludes:

> the actual source of this income was the credit made available by way of loan under the agreement made in the Netherlands in the course of the respondent's business in that country.... the source of the income was the business transaction carried out in the Netherlands...[51]
> ... the source is located where the transaction from which the debt took its origin took place...[52]

This is the place of credit test. It was said to be equivalent to the test of asking where the loan was made.[53] A particular attraction of this test is that it is fixed at the time the loan is made and does not change

Unfortunately this test does not resolve all the issues as one then has to ask where the credit was provided. The answer may not be obvious.

The facts of *Philips* were also slightly complicated and unusual. The debtor (a New Zealand company) owed a trading debt of £80k to the creditor (a Dutch company). The debtor was unable to pay. Rather than leave that loan outstanding, the creditor then lent £80k to the debtor to pay the trading debt (ie the old debt was paid and a new one came into existence). Payment of the borrowed money was made in a convoluted way: the Dutch company creditor drew a cheque sent it to the New Zealand company which then endorsed it and returned it to the Dutch company. The loan agreement was made in Holland, governed by Dutch law, and the money was not received in New Zealand. On these facts the credit was not provided in New Zealand, so the source of the interest was not in New Zealand.

The High Court of Australia applied the same test in *Studebaker Corporation of Australasia v Commissioner of Taxation for New South Wales* where the fact were more straightforward: an Australian debtor paid interest on a trade debt arising on the purchase of cars from America. The interest did not have source in Australia.[54]

51 [1955] NZLR] at p. 809, 891.

52 p.898.

53 p.899.

54 (1921) 29 CLR 225 accessible *www.austlii.org* at p.233: "The attribution of locality to the obligation to pay interest is not decisive. The facts must be examined, and when we find that the interest arises from business transaction and wholly carried out in America the conclusion must be that it was not derived from any source within new South Wales."

The Appeal Division of South Africa applied the same test in *IRC v Lever Bros* where a South African debtor paid interest on a debt arising on the purchase of UK shares from a UK vendor under a UK contract. The interest did not have a source in South Africa.[55]

The High Court of Singapore has adopted the same test.[56]

11.12.5 *Spotless*

The source of interest was also an issue in *Commissioner of Taxation of the Commonwealth of Australia v Spotless Services*.[57] Here the court took a balancing exercise approach:

> 52. Where, as in the present case, the transaction is complex in terms of its background, its nature and its execution, and where, as here, important aspects of the transaction have their origin in locations in several different countries, it will usually be difficult to identify the real source of income so generated. To attribute "source" is a matter of judgment, and of assessment, of the relative weight of all of the relevant surrounding circumstances.

However, the place where the money was lent was a major factor in the balancing exercise:

> 11. In weighing the factors to be taken into account when reaching a conclusion as to the source of the income, his Honour gave considerable weight to the place where the contract was made and where the money was lent. These events, his Honour found, occurred in the Cook Islands. His Honour continued (25 ATR at 361; 93 ATC at 4,411):-
>
> > "There are other facts and circumstances that in my view point strongly in the direction of the conclusions that the interest was derived by the taxpayers in the Cook Islands. The borrower,

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55 [1946] AD 441, 14 SATC 1 accessible *www.kessler.co.uk*.

56 *CH Pte Ltd v Comptroller of Income Tax* (1988) 1 MSTC 7022 accessible *www.kessler.co.uk*. In this case an agreement was made in Malaysia, but (which is considered to be the key fact) the money lent was received in Singapore. (A cheque received outside Singapore but paid into a Singapore account constitutes a receipt in Singapore.)

57 I could not find the case on *www.austlii.org* so have put it on *www.kessler.co.uk*. The case went on to the High Court of Australia but the source point was discussed only at first instance and in the Court of Appeal.

> EPBCL, was incorporated in the Cook Islands and carried on business there. It did not carry on business in Australia. The deposit was repaid, together with interest, less withholding tax, from the Cook Islands. It is impossible to ignore the legal effect of the arrangements entered into by the parties with respect to the lending of the money. Until the cheque for $40m was handed over on 11 December in the Cook Islands (10 December CI time) and the certificate of deposit received in return there was no contract between the lender (the taxpayer) and the borrower (EPBCL). If EPBCL failed to honour the certificate of deposit on the due date the taxpayers could have sued on the certificate and there would have been no answer in law to their right to judgment."

> 12. Once the contention that the contract was in reality made in Australia and that what occurred in the Cook Islands was a mere "formal step designed to screen the reality" is rejected and the banker's letter of credit issued by Midland is seen for what it was, a security to secure performance by EPBCL of repayment of the loan with interest, and not as an investment in itself, the matters contended for by the Commissioner as matters of practical substance sourcing the interest in Australia are either not factually correct or not sufficient to outweigh the Cook Islands elements.

11.13 HMRC view(s)

11.13.1 *HMRC view before 1979*: *IHT/international law situs rules*

The IR consultative document Tax Treatment of Interest paid by Companies to Non-residents[58] provides:

> "In the case of a simple contract debt it is settled law that the source is where the debtor is resident. Before the ending of exchange control, the Revenue was normally able to accept that interest paid abroad in a foreign currency under a specialty contract (ie a contract under seal governed by foreign law) to a non-resident could have a foreign source, even though the payer was a UK resident company."

This (more or less) adopts the IHT/international law situs approach to location of a source, which is rejected in this book.[59]

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58 January 1983 accessible *www.kessler.co.uk*.

59 See 11.11.4 (Situs of debt: location of deed if debt is a specialty).

This view survives in the Double Taxation Relief Manual:

> **1730. Interest**
> There is sometimes some difficulty in deciding whether interest is treated as having a UK source where the borrowing is made by a UK branch. ...
> The leading case on this subject is a Privy Council decision on a Hong Kong estate duty matter (*Kwok Chi Leung Karl* [1988] STC 728). The Privy Council decided that where a debtor company has two places of residence where a debt may be enforced, the locality of the debt (and its source for tax purposes in the absence of statutory provision to the contrary) falls to be determined by reference to the place of residence where under the contract creating the debt the primary obligation is expressed to be performed (that is where the creditor would apply first for his money).

Kwok concerned situs for estate duty, applying IHT/international law rules.

11.13.2 *HMRC view 1979–1993: residence of debtor*

The consultative document continues:

> The abolition of exchange control has meant that a transaction in the form of a foreign specialty contract can now take place entirely between UK residents. The Revenue therefore now generally has to regard interest paid by a UK borrower as having a UK source, whatever the nature of the contract ...

This (more or less) equates source with residence of the debtor. The Revenue forthrightly admit that their change of view was made for pragmatic reasons and not by reference to the law. In the circumstances it is not altogether surprising that their view could not be maintained, though it did apparently last for 15 years.

11.13.3 *HMRC view 1993–2008: balance all factors*

HMRC next changed their position in RI 58 (November 1993):

> **Schedule D Case III—meaning of "source"**
> ...The current [HMRC] view on the location of the source for interest

> is based on ... the Greek Bank case. The factors considered relevant in that case (leading to the conclusion that the income involved did not have a UK source) were—
> – there was an obligation undertaken by a principal debtor which was a foreign corporation;
> – the obligation was guaranteed by another foreign corporation with no place of business in the UK;
> – the obligation was secured on lands and public revenues outside the UK;
> – funds for payments by the principal debtor of principal or interest to residents outside Greece would have been provided either by a remittance from Greece or funds remitted by debtors from abroad (even though a cheque might be drawn in London).
>
> Although the Greek Bank case was concerned with income which turned out not to have a UK source, inferences can be drawn from that case about the factors which would support the existence of a UK source and [HMRC] regard the most important as—
> [a] the residence of the debtor, that is the place in which the debt will be enforced;
> [b] the source[60] from which interest is paid;
> [c] where the interest is paid; and
> [d] the nature and location of the security for the debt.
>
> If all of these are located in the UK then it is *likely* that the interest will have a UK source.
>
> (Emphasis added)

This adopted a balance all the factors approach. This is not supported by *Bank of Greece,* though it is supported by *Spotless.*

Assuming one does adopt that approach, "likely" was a timid word to use when all these connecting factors point the same way. The problem is when different connecting factors point different ways as they frequently do. Here the RI copped out:

> It is not possible for [HMRC] to comment individually in advance on

60 [Author's Note] I think this expression means the situs (on IHT/international law principles) of the funds from which the interest is paid. This seems to be the meaning of the expression in *Bank of Greece.* It does not mean the location on IT principles of the source of income out of which the interest is paid (which could of course be different).

> the many cases in which the location of the source of interest may be relevant since the precise tax treatment depends on all the factors and on exactly how the transactions are in fact carried out.

RI 58 ended with wishful thinking:

> [HMRC] hope that this summary of [their] views will assist practitioners and their clients in determining for themselves where the source of interest with which they may be concerned is located.

11.13.4 *HMRC view from 2009: balance all factors*

HMRC did not announce a change of view, but from 2008 the SAI Manual takes a slightly different line, and RI 58 is now described as "superseded by SAIM 9090 onwards".[61] I take that to be notice that HMRC have withdrawn from it.[62]

The SAI Manual also adopts a balance all the factors approach but it offers us a different selection of factors, and an indication of priority:

> **9090. Yearly interest: UK source: The general rule** [January 2009]
> Whether or not interest has a UK source depends on all the facts and on exactly how the transactions are carried out. HMRC consider the most important of factor in deciding whether or not interest has a UK source to be
> [a] the residence of the debtor and the location of his/her assets.
> Other factors to take into account are
> [b] the place of performance of the contract and the method of payment;
> [c] the competent jurisdiction for legal action and the proper law of contract;

61 In the Yellow Book 2008/09 and in HMRC online version of tax bulletin 9 accessible *www.hmrc.gov.uk/bulletins/tb9.htm*.

62 However International Manual para 342030 [October 2007] still supports RI 58: "The meaning of UK-source in this context will not normally give rise to difficulties. However, where the payer of the interest is not situated in the UK, it is still possible that such payments will fall to be considered under domestic tax law as having a UK-source. The onus is on the payer to decide whether tax is properly to be deducted having regard to settled case law principles [!] and all the facts surrounding the loan. In particular, the payer should refer to the approach and criteria endorsed by the House of Lords in the National Bank of Greece case (46 TC 472). The Inland Revenue position in that case is outlined in Tax Bulletin 9 of November 1993 [RI 58]."

> [d] the residence of the guarantor and the location of the security for the debt.
>
> This list of factors is derived from the leading case on the source of interest, *Westminster Bank Executor and Trustee Company (Channel Islands) Ltd v National Bank of Greece SA* (46 TC 472).
>
> HMRC consider the residence of the debtor to be most important because this, along with the location of the debtor's assets, will influence where the creditor will sue for payment of the interest and repayment of the loan.

The SAI Manual then defines "residence":

> 'Residence' in these circumstances is not the same as tax residence. Residence of the debtor is residence for the purposes of jurisdiction.[63]

If clarity is ever to enter this area of law, the first necessity is not to use the word "residence" (which has a specific meaning in tax) to mean a concept which has little connection with residence. It is not always true (perhaps not even generally true) that the tax-residence of the debtor is the place the debt will be enforced.[64] I shall reluctantly refer to the concept as "**jurisdiction-residence**" to distinguish it from tax-residence.

The SAI Manual then turns to consider how to identify jurisdiction-residence, in a passage which well illustrates the difficulties in using jurisdiction as an indication of source:

> **EU rules**
>
> If the debtor is resident within the EU, the Council Regulation (EC)

63 [Author's Note] The International Tax Handbook expands on this at para 1103:

> "An important factor in determining the source of interest is the residence of the debtor. 'Residence' does not, however, necessarily mean tax residence, rather it means where the [debtor] company has a business presence and can be sued for the debt. If it has more than one such presence then the source will normally be where, under the contract, the company is primarily required to pay the interest and repay the principal. It is, therefore, possible for a UK resident to pay interest which has an overseas source if a borrowing is made and interest is paid by an overseas branch. Likewise it is possible for a UK branch of a non-resident company to pay UK source interest."

This is based on (or at least consistent with) IHT/international law situs principles: see 59.10.2 (Dual resident debtor).

64 See 59.10 (Simple contract debt). In *Bank of Greece* the debt was enforceable in the UK but the interest was not UK source.

44/2001 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial matters, and the 1968 'Brussels Convention', may have an impact on the general rule described above. The usual rule is that where an individual is domiciled in a contracting state, then they should be sued in the courts of that state (Article 2 of the Regulation/Convention). Domicile is defined according to the rules of that contracting state but for these purposes only, it is, in the UK, linked to the individual's residence. Under these rules an individual is domiciled in England for example if he is resident there and the nature and circumstances of his residence indicate that he has a substantial connection with England. So an individual resident in England would in general terms only be sued in the courts in that country. However this is a complex area and there are exceptions. For example it may be argued that:

[1] the case does not fall within the Regulation;
[2] another convention or international agreement gives jurisdiction to another state's courts
[3] proceedings have already begun in another state's courts; or
[4] it has been agreed under Article 22 of the Brussels Convention[65] that the courts of a particular state have exclusive jurisdiction.

In practice points [1] to [3] will be very uncommon, but point [4] is very common, as the parties may agree any jurisdiction which suits them. What happens then? HMRC will not say (I expect they do not know):

> In any case in which it is argued that a UK resident debtor can be sued in a Member State in precedence to the UK courts please refer the case to CT&VAT (Financial and Insurance Team).

The SAI Manual considers interest paid by companies to be different:

> **9095. Yearly interest: UK source: Companies**
> *Interest paid by companies*

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65 I think the reference should be Article 23 Council Regulation (EC) No 44/2001 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters, which provides:

> "1. If the parties, one or more of whom is domiciled in a Member State, have agreed that a court or the courts of a Member State are to have jurisdiction to settle any disputes which have arisen or which may arise in connection with a particular legal relationship, that court or those courts shall have jurisdiction..."

> In deciding whether or not interest has a UK source, in addition to the factors described in SAIM9090, there are other matters to be taken into account for companies.
>
> **Companies and branches**
>
> Where the debtor is a company it may of course have more than one residence – for example it may be registered in a US state but managed and controlled from the UK.[66] Jurisdiction in relation to a corporation will in general depend on where the corporation does business (except where the EU Regulation or the 1968 Convention apply – see SAIM9090). So for these purposes it will be resident where it carries on business. If a debtor company has a number of places of residence/business then to decide the location of the debt you have to look at the terms of the loan agreement. The loan agreement should say where the interest and loan are payable, which (if the company is also resident in that place) will determine whether or not the interest has a UK source.
>
> When it comes to considering loans made to a branch of a UK company the source of the interest is overseas if all the following factors apply:
>
> [1] an overseas branch of a UK resident company has entered into a loan agreement overseas;
> [2] the loan is for the business of the overseas branch;
> [3] the overseas branch pays the interest from its income;
> [4] the loan agreement obligations are enforceable in the jurisdiction in which the branch is situated.

The paragraph does indicate a "safe haven" situation where one can be confident that the interest paid by a UK resident payer does not have a UK source.

The SAI Manual continues:

> Conversely, where a branch of a non-UK resident company enters into a loan agreement in the UK for the business of its UK branch and the UK branch pays the interest then the interest is regarded as having a UK source.
>
> **Companies within the EU**
>
> Under both the EU Regulation and 1968 Convention, domicile is the main ground of jurisdiction and will, at first sight, determine the rules for the recoverability of debts. EU regulation 44/2001 provides for a

66 The example is not correct, unless "residence" is being used here in a non-standard way, but it does not matter.

definition of domicile for corporations so that the company is domiciled where it has its statutory seat (in the UK its registered office), central administration or its principal place of business. However it is important to note that a corporation is not domiciled in a country for these purposes merely because it does business there. If an EU based company carries on business in a country in which it is not domiciled you have to consider the terms of the loan agreement to determine the situation of the debt. For example, if a company which has its principal place of business in the UK also carries on business in another Member state, where the interest and loan are payable in that other Member state and that member state's courts have jurisdiction then the interest will be non-UK source.
For branches of EU companies the position is as described above for branches generally.

11.13.5 *Interest from securities*

FB EN 2008 makes a useful comment:

> 77. ... Section 644 ITA treats an individual chargeable on the remittance basis as an excluded transferor or transferee, if the transfer is of a "foreign security". Securities are "foreign" where income from them (in practice, interest) would be relevant foreign income. This would include, for example, a security issued in registered form by a non UK company, which maintains the register of note-holders outside the UK.

The rule that the source of interest on registered bonds of a foreign company is the location of the register seems a sensible rule and is consistent with *Bank of Greece*.

11.14 Source of interest: conclusion

It is submitted that the courts ought to hold that the source of interest is where the credit is provided, or where money is lent, i.e. where the money lent is received (the two phrases being understood to come to the same thing). This is consistent with case law, principle, international practice (at least in Hong Kong) and provides an element of certainty.[67] The

67 I would be grateful to readers who could direct me to statements of practice from other common law jurisdictions.

English courts are not bound to follow it, however.

If, contrary to that view, a balance of all the factors approach is preferred, along the lines of SAI Manual 9090, it is suggested that the position should be as follows:

(1) Suppose a debt were wholly non-UK connected but secured on UK land; that is, the UK situate security is the only UK aspect of the debt. For instance, a debt from one non-resident to another non-resident, which arises under a contract governed by a foreign proper law. There is no definite answer to this but it is suggested that interest on such a debt has a foreign source. It would be wiser to avoid the issue.

By contrast, suppose a debt was made unsecured (or secured on non-UK assets) and later became secured on UK land. It is considered that this would not turn a non-UK source into a UK source.

(2) Suppose a debt were wholly non-UK connected but paid out of funds derived from UK source income (e.g. rents of UK land). This cannot be enough to make the interest UK source. The origin of funds used to pay interest is a weak connecting factor. (I would submit it should not be a connecting factor at all.)

(3) Suppose a debt were wholly non-UK connected but had a UK resident debtor. It is suggested that this alone does not give the source of interest a UK location.[68]

11.14.1 *Commentary*

HMRC correctly say:

> The current tests in UK law of whether, for the purposes of deduction of tax, payment of interest is made from a UK source are unclear and cause confusion.[69]

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68 Christopher Norfolk points out that s.348(4)(d) ICTA (now repealed) assumed it was possible for a UK resident to pay interest with a non-UK source.

69 "Income tax: Meaning of UK Source for Payments of Interest and Royalties" Consultation document 10 December 2003, para 1.1. The courts have made the same point: " Where ... the transaction is complex in terms of its background, its

It is surprising that the question of the source of interest has not given rise to more litigation or to clearer principles. The reason may be that HMRC have in practice taken a relaxed view on source (which no doubt encourages taxpayers to take a relaxed view on disclosure). Of course, there is no guarantee that will continue. Also, DTTs sometimes render the point irrelevant.[70]

A more sensible test would be the test in the OECD Model Treaty.[71] Legislation (with appropriate transitional provisions) would be needed to make this reform. The gap between the existing case law and this solution is too great to be bridged by the courts, except by the House of Lords. A HMRC consultation document in 2003 proposed this sensible reform but the proposal was quietly dropped. The reason why was never announced. Tax reforms generally have winners and losers. The losers cry louder than the winners, and that is an obstacle for many tax reforms. But it is not clear that this was the case where since it is hard to identify significant classes of "losers", ie persons who could say with any confidence that they were not taxable under the present law.

11.15 Income from interest in possession type trusts: identifying the source

11.15.1 *Introduction*

The choice is between:

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nature and its execution, and where ... important aspects of the transaction have their origin in locations in several different countries, it will usually be difficult to identify the real source of income so generated."

70 See 29.6 (Double tax treaty defence).

71 Article 11(5) OECD Model Treaty provides:

> "Interest shall be deemed to arise in a Contracting State when the payer is a resident [i.e. treaty-resident] of that State. Where, however the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated."

The only way which this might be changed is to deal with the special case of a change of residence.

(1) regarding the trust as the source of trust income; or
(2) regarding the trust assets as the source, in which case one "looks through" the trust and it is described as "transparent".[72]

The answer depends on the terms of the trust, construed in accordance with the proper law of the trust.

11.15.2 *England and other "Baker" jurisdictions*

The source of income is the underlying trust assets (not the trust) if, under the terms of the trust, construed in accordance with the proper law of the trust, the beneficiary is entitled to the income of each trust asset as it arises. This is the case for a standard form interest in possession trust governed by English law.[73]

Rather surprisingly, this applies even if the life interest is subject to an annuity: *Nelson v Adamson* 24 TC 36. But in practice annuities are not used so the point is only of academic interest.

It is possible to draft an English law trust so that under the terms of the trust the beneficiary is not entitled to a proprietary interest in the income as it arises, but merely has the right to call on the trustees to transfer to him "a balance" of net income.[74] Then the trust (not the underlying assets) will be the source. In practice this is not normally done.[75]

11.15.3 *New York and other "Garland" jurisdictions*

However, common form interest in possession type trusts under some foreign jurisdictions do not give the beneficiary the right to income as it arises, but only the right to recover a sum from the trustees. The right is *in personam* not *in rem*. In this case the trust is not transparent.

This is so even if the beneficiary is described as "life tenant" and is, in economic reality, in the same position as a life tenant under an English law trust. Such a trust is more like an English law estate than an English law

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72 See 62.1.1 ("Transparent" and "opaque").

73 *Baker v Archer-Shee* 11 TC 749. See "The Nature of a Beneficiary's Interest" 45 CBR 219.

74 *R v Special Comrs ex p Shaftesbury House & Arethusa Training Ship* 8 TC 367 appears to be an example. But that case was decided before *Baker*, and it should be decided differently now.

75 Except perhaps unit trusts: see 27.2.3 (Unauthorised unit trust: foreign trustees).

trust.

This approach requires one to ask whether every trust jurisdiction is:

(1) a *Baker* jurisdiction (where the life tenant of a standard form IP trust has a right to income as it arises); or
(2) a *Garland* jurisdiction (where the life tenant only has a right against the trustee).

This is a somewhat meaningless question, because the issue only matters for tax. One may then have to consider the effect of non-standard wording.

The English courts assume that foreign trust jurisdictions apply English law principles in the absence of evidence to the contrary. But the Scottish courts will, I expect, assume Scots law principles, in the absence of evidence, with the opposite result. Fortunately, HMRC have published a list of jurisdictions divided into *Baker* and *Garland* jurisdictions which is discussed in appendix 1.

This only represents the HMRC view and could be challenged on the basis of expert evidence. It may be possible to draft a transparent trust in a *Garland* jurisdiction by using non-standard wording. This raises questions of foreign law. It would in principle be possible to draft a non-transparent trust in a *Baker* jurisdiction.

11.15.4 *Scots trusts*

It is generally accepted that a liferent (i.e. life interest) under a Scots trust in common form is not transparent.[76]

This has been reversed for UK resident Scots trusts; s.464 ITA provides:

76 "There is no difference between the law of Scotland as regards the beneficiary's rights and the law which is admitted in the record to be the law of the State of New York." *Inland Revenue v Clark's Trustees* [1939] SC 11 at p.24 accessible *www.kessler.co.uk* approved by Lord Fraser in *Leedale v Lewis* 56 TC at p.538. See too Discussion Paper on the Nature and the Constitution of Trusts para 2.5:

> "The beneficiary has a … right to compel the trustee to administer the trust funds in accordance with the provisions of the declaration of trust. This is a personal right. It is axiomatic that in Scots law the beneficiaries do not have a real right or a quasi-real right in the trust property. They have no proprietary interest in the trust fund."

Scottish Law Commission 2006 accessible *www.scotlawcom.gov.uk*.

> **Scottish trusts**
> (1) This section applies if—
> (a) income arises to trustees under a trust having effect under the law of Scotland,
> (b) the trustees are UK resident, and
> (c) a beneficiary under the trust ("B") would have an equitable right in possession to the income if the trust had effect under the law of England and Wales.
> (2) B is treated for income tax purposes as having an equitable right in possession to the income (even though B has no such right under the law of Scotland).

It is difficult to see why the statutory rule only applies to UK resident trusts. It is difficult to see why it applies to Scotland and not other *Garland* jurisdictions. The reason is that it is not part of a coherent regime for the taxation of trusts but a late Finance Bill amendment to deal with a narrow domestic anomaly.[77] In practice it will not often matter.

One can create a transparent Scots law trust with appropriate wording.[78]

11.15.5 *The Garland concession*

International Manual provides:

> **166030. Garland trusts** [December 2006]
> In the case of income of a non-discretionary foreign trust of the type considered in the case of *Garland v Archer Shee* 15 TC 693, the beneficiaries are not concerned with the source of the trust income and whether or not it has borne UK tax. It is the practice to allow relief to beneficiaries, other than annuitants, in respect of the proportion of the income assessable under Case V which is regarded as being derived from trust income which has borne UK tax. It is a condition of the relief that the amount of the income for higher rate purposes is to be treated as the sum of the amount assessable under Case V and the amount of tax

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77 See Discussion Paper on Apportionment of Receipts and Outgoings para 4.5, Scottish Law Commission, 2003, accessible *www.scotlawcom.gov.uk/downloads/dp124_trust_receipts.pdf.*

78 "Scottish Trust beneficiaries are not entitled to specific items of trust property *unless that is expressly provided for in the Trust Deed*." Discussion Paper on Apportionment of Receipts and Outgoings para 4.5.

> on a grossed up basis which is applicable to the part of the assessment on which relief has been given.
> Submit the first claim from a beneficiary for this relief to the Offshore Personal Tax Team (part of Charity, Trusts & Residence), before admitting the claim.
> **166031–166039.**
> **166040. Foreign tax**
> Where foreign tax has been paid on trust income (including, in the case of dividends, any underlying tax where, exceptionally credit for such tax is due under the terms of an agreement – see INTM164410), it is the practice, in the case of a trust of a type referred to in INTM166030, to allow credit relief to beneficiaries, other than annuitants, for that foreign tax. Credit relief is given in the same way and to the same extent as if each beneficiary were entitled to his proportionate share of the underlying investments of the trust.

I refer to this as "**the Garland concession**".

11.15.6 *Commentary*

The distinction between *Baker* and *Garland* jurisdictions should be abolished. It has no economic substance and precious little legal basis. It is to a large extent undone by the Garland concession. Section 464 ITA should be extended to apply to all *Garland* trusts.

11.16 Distributed income of discretionary trust: what is the source?

Where the trust is a common form discretionary trust and a beneficiary receives trust income in the exercise of the trustees' discretion, the same choice arises between:

(1) regarding the trust (or the trustees' dispositive power over income) as the source of the beneficiary's income; or
(2) regarding the trust assets as the source.

The conventional view is that the trust is the source (not the underlying trust assets). This is supported by *Re Vestey* [1951] Ch 209; *IRC v Berrill*

55 TC 429 at 444 and *Memec v IRC* 71 TC 77 at p.95.[79]

If a discretionary trust becomes interest in possession in form, the trustees' discretion over income in principle comes to an end and the source has ceased: *IRC v Berrill* at p.444. A more cautious course (if cessation is essential) would be to wind up the trust, as then the source has certainly ceased.

Where the beneficiary is entitled to an annuity or other annual payments from the trust, which is not a simple distribution of trust income, the trust is necessarily the source.[80]

11.17 Charge on income from discretionary trusts

Sections 683 and 684 ITTOIA provide:

> (1) Income tax is charged under this Chapter on annual payments that are not charged to income tax under or as a result of any other provision of this Act or any other Act.
>
> ...
>
> (3) The frequency with which payments are made is ignored in determining whether they are annual payments for the purposes of this Chapter.[81]

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79 Robert Venables QC disagrees: PTPR (1999) Vol. 7 p.87 ("*Memec v IRC* and the Source of Discretionary Income Payments from Trusts"); *Non-Resident Trusts*, 8th edition, 16.3 (Taxation of Beneficiary):

> "Where there are discretionary trusts of income ...and the trustees distribute income in the exercise of their discretion, the taxability of the recipient beneficiary is a matter of some controversy. My own opinion is that in exercising their discretion the trustees simply perfect the settlor's gift so that the position at the end of the day is the same as if the trust instrument had expressly provided that the beneficiary should receive the income. Thus, the income which the beneficiary receives is the same income as that which the trustees received, the beneficiary's source is the same as the trustees' source and any tax paid by the trustees is to be treated as having been paid on account of the beneficiary."

This was assumed to be correct in *Drummond v Collins* 6 TC 525 but the point was not directly considered. Maybe the law could or should have gone down that road but it cannot do so now. Much statute law is drafted on the contrary view. The law should be regarded as settled.

80 *R v Special Comrs ex p. Shaftesbury Homes & Arethusa Training Ship* 8 TC 367; *Inchyra v Jennings* 42 TC 388.

81 ITTOIA EN explains: Subsection (3) rewrites "or whether the same is received and payable half-yearly or at any shorter or more distant periods".

...

684 Income charged

(1) Tax is charged under this Chapter on the full amount of the annual payments arising in the tax year.

(2) Subsection (1) is subject to Part 8 (foreign income: special rules).

Distributions from trusts (if of an income nature) are "annual payments".

11.18 Payment from discretionary trust: income or capital?

The position depends on the terms of the power under which the payment is made.

11.18.1 *Power over income*

A common form discretionary trust[82] provides this type of power over trust income:

> The Trustees may pay or apply the trust income to or for the benefit of any Beneficiaries, as the Trustees think fit.

If trustees receive income and make a payment under such a power, the receipt is income and not capital. This has never been doubted.

11.18.2 *Power over capital*

A common form discretionary trust also provides this type of power over trust capital:

> The Trustees may pay or apply the capital of the Trust Fund to or for the advancement or benefit of any Beneficiary.

If trustees make a payment under such a power the receipt is capital and not income. This is still the case even if:

(1) the payments are made to satisfy an "income purpose", e.g.

82 For a discussion of the drafting, see *Drafting Trusts & Will Trusts*, James Kessler, 9th ed., Chap 15 (Discretionary Trusts).

maintenance of a beneficiary; and
(2) the payments are recurrent (e.g. annual or even monthly).

This follows in the author's view from *Stevenson v Wishart* 59 TC 740. The judgment of Knox J is clearer on this point than the Court of Appeal.

11.18.3 *Accumulated income paid out as income*

A common form discretionary trust allows trustees to accumulate income, and add it to trust capital. However, trustees usually have power "to apply the accumulations as if they were income arising in the then current year". If trustees make a payment out of trust capital under such a power the receipt is an income receipt of the beneficiary. The important point is that the terms of the relevant provision of the settlement link the payment with an income interest of a beneficiary. See the comment of Knox J in *Stevenson v Wishart* 59 TC 740 at 757D.

It might be rather clearer if the trust accounts recorded an "Accumulated Income Fund" (instead of recording accumulated income as increasing the capital fund). However, this is not strictly necessary.

11.18.4 *Accumulated income paid out as capital*

Suppose, lastly:

(1) trustees accumulate income and add it to capital; and
(2) the trustees pay that capital to a beneficiary in exercise of a power like that in para 11.18.2 (Power over capital).

The receipt is still capital and not income. This follows from *Stevenson v Wishart.* In that case the distributions which HMRC sought to tax as income represented original trust capital and not accumulated income. It is considered that this makes no difference. *Stevenson v Wishart* is authority for the proposition that the income/capital question is governed by the terms of the power concerned.[83]

However, in an extreme case, where for tax planning reasons there was an arrangement under which:

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83 Provisions such as ss.631(1)(2) and 633 ITA assume this is correct (deeming payments out of accumulated income to be treated as income).

(1) income was accumulated;
(2) the trustees pay that capital to a beneficiary (by exercise of a common form power of advancement or appointment) very shortly afterwards.

HMRC would have an attractive argument that the receipt should be regarded as income under general principles or under the rule in *Furniss v Dawson*. In practice it should be possible to avoid this by ensuring that advances of capital are not neatly identifiable with accumulated income.

11.18.5 *HMRC view*

HMRC agree with the views set out above. The TSE Manual provides:

> **3755. Beneficiary receives discretionary payment from a resident trust** [August 2007]
> Trustees of a discretionary trust have the power to decide how to apply the trust funds. They may pay from trust income or capital.
> Where the trustees make a discretionary payment from income, they usually give the beneficiary a form R185 (Trust Income). They have to do so if the beneficiary requests it.
> **3756. Beneficiary receives discretionary income payment from a resident trust: trust not settlor-interested** [August 2007]
> In the case of trusts or settlements that are not settor-interested a discretionary income payment is treated as an amount that is net of tax at the rate applicable to trusts. The beneficiary's income is the net amount grossed at the rate applicable to trusts. It carries tax credit at that rate. It is available for relief or repayment.
> The gross amount is an annual payment. It is a new source of income, usually not identified with the underlying trust income. *Cunard's Trustees v CIR* (27 TC 122) supported the view that when the trustees exercised their discretion, a new source of income came into existence. Certain beneficiaries can claim relief under extra-statutory concession B18. This allows them the exemption or reliefs they could have claimed if they had received the underlying trust income directly.
> ...
> **3758. Discretionary payment from trust capital** [January 2008]
> A discretionary payment made out of trust capital, including a payment out of accumulated income or out of a capital receipt that is deemed to be income for tax purposes, is usually not regarded as the income of the beneficiary. This view was supported in the case of *Stevenson v Wishart* (59 TC 740).
> Exceptionally, payments out of capital are treated as the income of the beneficiary where, by the terms of the trust instrument, payments out of capital are required to be made, or may be made, in order to supplement income. For example, the trustees may or have to make income up to
> - a fixed amount or

● a certain defined level as in *Cunard's Trustees v CIR* (27 TC 122)
Tax cases: *Cunard's Trustees v CIR* 27 TC 122; *Stevenson v Wishart* 59 TC 740
3759. Beneficiary receives discretionary payment from a resident trust: when payment made [August 2007]
For tax purposes the beneficiary receives a payment on
● The date the trustees made the payment or
● The date the beneficiary became legally entitled to require the trustees to pay over the income. This could be when the payment indefeasibly vested, following the trustees' resolution.
Tax cases: *Cunard's Trustees v CIR* 27 TC 122

The same point is made in the HMRC Trust & Estate Tax Return Guide (form SA950) for the year ended 5 April 2009:

boxes 14.1 to 14.14
Payments out of trust income are always the income of the beneficiaries. Payments out of trust capital or accumulated income are not to be regarded as the income of a beneficiary irrespective of the purposes for which they are made and should not therefore be included.
If, exceptionally, the terms of the trust empower the trustees to release monies in order to bring up a beneficiary's income to a certain defined level the total amount of the monies released should be included even if part of it represents capital or accumulated income.

11.19 Location of source when source is a trust

Where the trust is the source, how does one decide its location: the residence of the trustees; the proper law; the country in whose courts the trust will be enforced? It is suggested that trustee residence is the deciding factor, and this is consistent with ESC B18.

11.20 Canadian RRSPs, US IRAs, etc

The HMRC view was set out in the Inspectors Manual 1622 to 1625:

1622. Canadian RRSPs Published: 9/95
Canadian Registered Retirement Savings Plans (RRSPs) are tax-deferral vehicles commonly used by taxpayers working in Canada to provide an income or lump sum on retirement. The plan holder is permitted to set aside a certain proportion of his income (on which relief from Canadian tax is received) for investment either directly by the individual or, more usually, through a financial institution such as a bank or insurance company. On retirement or earlier, the

taxpayer may withdraw a lump sum from the Plan or roll-over the proceeds into the purchase of an annuity. A lump sum withdrawal is subject to Canadian income tax, but if the proceeds are reinvested in an annuity, only the annuity is taxed.

The tax consequences for a UK-resident holder of an RRSP are as follows:

1) income invested in the Plan is not eligible for UK tax relief;
2) the Plan is treated as 'fiscally transparent', that is income arising within the Plan is taxable in the UK as if the Plan did not exist, notwithstanding the tax-free accrual of income in Canada.
3) a lump sum withdrawal from the Plan is not taxable as such but the disposal of assets held within the Plan to effect the withdrawal may produce a UK tax charge. For example, a disposal of chargeable assets held within the Plan might produce a capital gains tax charge.
4) if an annuity is purchased the non-capital element will be taxable under Case V of Schedule D (see AP896 onwards). A purchased life annuity should be submitted to Financial Institutions Division 1 for determination of the proportion of the annuity which should be regarded as capital.
5) Canadian withholding tax at a rate of 25 per cent is deducted from withdrawals made by Plan holders who are not-resident in Canada. No tax credit relief is available in the UK for this tax where a tax charge arises in the UK (see (3) above), because the Canadian tax is imposed on a lump sum withdrawal from the Plan, whereas UK tax is imposed on gains resulting from the disposal of assets held within the Plan.
6) under Canadian domestic law, tax at 10 per cent may be withheld from payments of annuities derived from RRSPs, but it is understood that the Canadian tax authorities take the view that where such annuities are paid to UK-residents they will be exempt from Canadian tax under Article 17(1) of the Canada/UK Double Taxation Convention. If a taxpayer claims credit for Canadian tax paid on an annuity he should be advised to seek repayment from Revenue Canada and credit relief will not be allowable in the UK.

1623. Canadian RRIFs Published: 9/95

When an RRSP (see IM1622) matures, the Plan holder may, as an alternative to withdrawing the funds or buying an annuity, use the property held within the Plan to establish a Registered Retirement Income Fund (RRIF).

An essential feature of an RRIF is that a minimum amount, arrived at by dividing the fair market value of the property held within the Fund at the beginning of the year by the difference between 90 and the age of the Fund holder at the beginning of the year, must be paid out to the investor each year. In this way, cash benefits are provided each year up to age 90. If, in any particular year, additional funds are required, these may be withdrawn, so long as the total does not exceed the value of the property held in connection with the Fund immediately before the withdrawal.

Income arising within an RRIF is tax-free in Canada, but there is a Canadian tax charge on withdrawals from the Fund.

For UK tax purposes, the treatment of RRIFs follows that for RRSPs indicated at IM1622(2), (3) and (5). It is understood that Revenue Canada regards the payments made each year as pension income and treats them as exempt from Canadian tax where paid to a UK-resident, under Article 17(1) of the UK/Canada Double Taxation Convention. The Canadian concept of 'periodic pension income' has no relevance, however, in the UK, where it is the income earned by the Fund's investments which is taxable, while withdrawals do not themselves attract a UK tax charge.

Any cases of doubt or difficulty concerning either RRSPs or RRIFs should be referred to Revenue Policy, International, (Cases IV & V), Victory House for advice.

1624. United States Individual Retirement Accounts

Published: 9/95

Individual Retirement Arrangements are United States tax shelters for working US taxpayers wishing to provide for their retirement. They are broadly similar to Canadian RRSPs (see IM1622).

There are two types of Individual Retirement Arrangement, an 'Individual Retirement Account' (IRAC) and an 'Individual Retirement Annuity' (IRAN). An IRAC is a trust (or similar arrangement known as a custodial account) set up for the exclusive benefit of the taxpayer and, on his death, nominated beneficiaries, which satisfies certain conditions imposed by United States tax law. Contributions to an IRAC are tax deductible in the United States and the funds can be invested in a wide range of investments. IRAC funds can be withdrawn at any time, but if withdrawals are made before the taxpayer reaches the age of 59½ he must pay an additional penalty tax of 10 per cent unless he is disabled.

Provided that the taxpayer does not nominate a beneficiary to receive the balance of the IRAC on his death, the trust is transparent for the purposes of UK Income Tax. Income on IRAC investments is accordingly assessable on the taxpayer under Case IV or V of Schedule D as appropriate, whether or not withdrawals from the IRAC are made.

The nomination of a beneficiary creates a settlement within the terms of the provisions of ICTA, s 672. In such a case the taxpayer is liable to UK Income Tax under Case VI of Schedule D on the IRAC income arising in the tax year (ICTA, s 675).

Whether or not a beneficiary has been nominated, an IRAC is a bare trust for the purposes of TCGA, s 60. The taxpayer is therefore chargeable to UK Capital Gains Tax in respect of any chargeable gains arising on the disposal of IRAC investments. Changes in IRAC investments will generally involve acquisitions and disposals of chargeable assets by the taxpayer.

Withdrawals from an IRAC do not of themselves give rise to a charge to Income Tax or Capital Gains Tax, but they will often be preceded by the disposal of IRAC investments (including the conversion of dollars to sterling) giving rise to a chargeable gain or an allowable loss.

However Q11 January 2009 Qs & As offers a different view:

Q11: ... My first retirement account is called a Roth IRA, similar to an

ISA in that it grows tax free forever and you are not taxed in the US when you withdraw from it during retirement. The other account is called a Traditional IRA which is similar to a UK personal pension in that growth is tax deferred, i.e. you only pay tax on the income that you take from it during retirement. ...
Could you confirm whether these US retirement vehicles will be subject to UK tax?
A: ...
IRAs – the UK/US Double Tax convention was amended in 2003 which made significant changes to the treatment of pensions (Article 17 of the convention). These comments apply to the UK tax years from 2003/2004.
Roth IRA – paragraph 1(b) of article 17 provides for a distribution to be exempt from tax in the UK to the extent that it would be exempt in the US. This means that withdrawals from this IRA should be exempt from UK tax.
Traditional IRA – the UK treatment follows the US treatment: sums are taxed on withdrawal. But, of course, if you make a claim for the remittance basis to apply you will only be taxed on sums remitted to the UK.

Inspectors Manual 16.25 dealt with US IRANs:

1625. United States Individual Retirement Annuities
Published: 9/95
Under Individual Retirement Annuities (IRANs), contributions are used to purchase an annuity from a life assurance company. No UK tax liability arises until the annuity becomes payable, when the annuity payments become chargeable under Case V of Schedule D.
If an IRAN life annuity was paid for partly or wholly by an employer, the whole of each annuity payment will be taxed as income, but if there was no employer's contribution the provisions of ICTA, s 656 apply so as to exclude the capital element. Any annuity within ICTA, s 656 should be submitted to Business Tax (Technical) for determination of the capital element.
Any cases of doubt or difficulty involving IRACs or IRANs should be referred to Revenue Policy, International, (Cases IV and V), Victory House.

11.21 Casual income

The BIM provides:

80110. Casual income: contracts made in UK/abroad
Where a contract which gives rise to casual income is made in the United

> Kingdom, the income may be chargeable under Case VI even where the services are to be performed outside the United Kingdom (see *Alloway v Phillips* 53 TC 372).

In *Alloway v Phillips* the place location of the income was place that the contract was enforceable. This is not a suitable test, as taxpayers can in principle chose what that place is, as the author of the Manual is aware:

> Where casual income arises from services performed in the United Kingdom and it is claimed that there is no Case VI liability because the contract was made abroad, the case should be referred to Business Tax (Technical) for advice before the absence of liability is agreed.

It is considered that the place where the work is done is the correct test.[84]

11.22 Maintenance payments

ESC A12 provides:

> **Double taxation relief: alimony, etc under UK court order or agreement; payer resident abroad**
> Where alimony or maintenance payments are paid under a UK court order or agreement, the income arises from a UK source regardless of the country of residence of the payer. Notwithstanding that the source is in law a UK source, relief by way of credit is, however, allowed where—
> (a) the individual making the payments has left the UK and become resident in an overseas country;
> (b) the payments are made out of that individual's income in that country and are subject to tax there;
> (c) UK income tax if deducted from the payments is duly accounted for; and
> (d) the payee is resident in the UK and effectively bears the overseas tax.

The INT Manual 161130 adds:

> Note, however, that a United Kingdom resident payee, may, if foreign tax has been deducted from alimony etc. payments, be entitled to exemption from foreign tax if the relevant double taxation agreement so provides (for example in a specific Article or in the other income Article

84 But contrast *Millin v IRC* [1928] AD 207 (South Africa).

– see INTM153200 and INTM153240). If this happens or is likely to happen, then invite the payee to make a claim to the foreign Revenue authority for repayment of any tax deducted and for exemption from tax on future payments. Guidance on how to make such claims are given in the entries relating to the respective individual countries.

Unlike the United Kingdom, which treats alimony etc. payments as a charge on the payer's income, many countries do not have similar provisions in their own taxation laws, so that such payments made by residents of those countries are made out of fully taxed income. A United Kingdom resident payee is not entitled to a measure of tax credit relief in respect of the foreign tax borne by the payer on his total income in these circumstances. The payments have not been subjected to tax in the foreign country and the payee has not been subject to nor has effectively borne the foreign tax (see (b) and (d) in the second sub paragraph above).

11.23 Royalties and know-how

ESC B8 provides:

B8 Double taxation relief: income consisting of royalties and "know-how" payments

Payments made by a person resident in an overseas country to a person carrying on a trade in the UK as consideration for the use of, or for the privilege of using, in the overseas country any copyright, patent, design, secret process or formula, trademark or other like property may in law be payments the source of which is in the UK, but are nevertheless treated for the purpose of credit (whether under double taxation agreements or by way of unilateral relief) as income arising outside the UK except to the extent that they represent consideration for services (other than merely incidental services) rendered in this country by the recipient to the payer.

See INT Manual 161130.

CHAPTER TWELVE

EMPLOYMENT INCOME

12.1 Overview and terminology of ITEPA

This chapter considers general earnings.

Benefits in kind are discussed in 54.6 (Home owned by company: benefit in kind charge), 54.35 (Chattels held by companies) and 30.5 (Employment-related loans).

For NICs see 35.1 (National insurance contributions).

The tax equalisation basis is not discussed here, but see Tax Bulletin 81.

12.1.1 *General earnings*

The early sections of ITEPA are awash with cross references and overviews. I omit them here. Cutting to the chase, s.6 ITEPA provides:

> **6 Nature of charge to tax on employment income**
> (1) The charge to tax on employment income under this Part is a charge to tax on—
> (a) general earnings, and
> (b) specific employment income.

These terms are defined in s.7 ITEPA:

> (1) This section gives the meaning for the purposes of the Tax Acts of "employment income", "general earnings" and "specific employment income".
> (2) "Employment income" means—
> (a) earnings within Chapter 1 of Part 3,
> (b) any amount treated as earnings (see subsection (5)), or
> (c) any amount which counts as employment income (see subsection (6)).
> (3) "General earnings" means—
> (a) earnings within Chapter 1 of Part 3, or
> (b) any amount treated as earnings (see subsection (5)),

excluding in each case any exempt income.
(4) "Specific employment income" means any amount which counts as employment income (see subsection (6)), excluding any exempt income.
(5) Subsection (2)(b) or (3)(b) refers to any amount treated as earnings under—
(a) Chapters 7 to 9 of this Part (agency workers, workers under arrangements made by intermediaries, and workers providing services through managed service companies),
(b) Chapters 2 to 11 of Part 3 (the benefits code),
(c) Chapter 12 of Part 3 (payments treated as earnings), or
(d) section 262 of CAA 2001 (balancing charges to be given effect by treating them as earnings).
(6) Subsection (2)(c) or (4) refers to any amount which counts as employment income by virtue of—
(a) Part 6 (income which is not earnings or share-related),
(b) Part 7 (income and exemptions relating to securities and securities options), or
(c) any other enactment.

Specific employment income is not discussed here.

12.1.2 *Net taxable earnings*

Section 9 ITEPA provides:

9 Amount of employment income charged to tax
(1) The amount of employment income which is charged to tax under this Part for a particular tax year is as follows.
(2) In the case of general earnings, the amount charged is the net taxable earnings from an employment in the year.
(3) That amount is calculated under section 11 by reference to any taxable earnings from the employment in the year (see section 10(2)).
[ss (4)(5) deal with specific employment income, not discussed here]]
(6) Accordingly, no amount of employment income is charged to tax under this Part for a particular tax year unless—
(a) in the case of general earnings, they are taxable earnings from an employment in that year, ...

"Net" taxable earnings is a label for the rules relating to deductions, not discussed here. The key expression is "taxable earnings".

12.1.3 *Taxable earnings*

Section 10 ITEPA provides:

> (1) This section explains what is meant by "taxable earnings" and "taxable specific income" in the employment income Parts.
> (2) "Taxable earnings" from an employment in a tax year are to be determined in accordance with Chapters 4 and 5 of this Part.

So we move on to chapter 4 part 2 ITEPA. Section 15 ITEPA provides:

> (1) This section applies to general earnings for a tax year in which the employee is UK resident.
> (2) The full amount of any general earnings within subsection (1) which are received in a tax year is an amount of "taxable earnings" from the employment in that year.
> (3) Subsection (2) applies whether or not the employment is held when the earnings are received.

Section 15 sets out the general rule (all earnings on an arising basis) to which there are a number of exceptions.

12.1.4 *Summary*

The taxation of employment income from 2008/2009[1] can be summarised in this table:

UK Resident	Ordinarily Resident	UK Domicile	Scope of charge	ITEPA Section	Part 2 Chapter
Yes	Yes	Yes	All earnings: AB	15	4
Yes	Yes	No	(1) CO earnings: RB (2) other earnings: AB	22(2) 22(7)→15	5
Yes	No	irrelevant	(1) non-UK duties: RB (2) UK duties: AB	26(2) 26(6)→15	5
No	irrelevant	irrelevant	(1) UK duties: AB (2) other duties: tax free	27 –	5

Key
AB: Arising basis
RB: Remittance basis
CO: Chargeable overseas

1 For reasons that are not entirely clear, the FA 2008 reshuffled the section numbers.

12.2 Resident, ordinarily resident and foreign domiciled employee

12.2.1 *Chargeable overseas earnings of ordinarily resident non-domiciled employee*

Section 809F ITA provides:

> (1) This section applies if section 809B, 809D or 809E applies to an individual for a tax year.
> (2) The individual's relevant foreign earnings for that year are charged in accordance with section 22 or 26 of ITEPA 2003.

So we turn to s.22 ITEPA which (somewhat repetitively) provides:

> (1) This section applies to general earnings for a tax year, to the extent that they are chargeable overseas earnings for that year, if—
> (a) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the employee for that year, and
> (b) the employee is ordinarily UK resident in that year.
> (2) The full amount of any general earnings within subsection (1) which are remitted to the UK in a tax year is an amount of "taxable earnings" from the employment in that year....

In short, the remittance basis applies to chargeable overseas earnings.[2]

12.2.2 *Non-CO earnings of ordinarily resident non-domiciled employee*

I use the term "**non-CO earnings**" to mean earnings which do not fall within the definition of "chargeable overseas earnings". Section 22(7) ITEPA provides:

> General earnings for the employee for the tax year fall within section 15(1) to the extent that they do not fall within subsection (1).

This is not strictly necessary, but it does no harm. The drafter put it in as a signpost, because the scheme of the pre-2008 provisions was different, and the charge on non-CO earnings of an employee who was ordinarily

2 Section 22(6) ITEPA provides: "See Chapter A1 of Part 14 of ITA 2007 for the meaning of 'remitted to the UK' etc."

resident and non-domiciled used to fall under s.22, not s.15.

12.2.3 *Transitional rules for pre-2008 earnings*

Suppose:

(1) Chargeable overseas earnings accrue to T before 2008/9 and
(2) The earnings are remitted in 2008/9 or later (when T is still resident).

In the absence of a transitional rule, the earnings would not be taxable under s.22 ITEPA because the condition in s.22(1)(a) would not be met. Sections 809B, 809D or 809E did not apply before 2008. Para 82(2)(a) Sch 7 FA 2008 fills that gap:

> (1) This paragraph applies in relation to an individual's general earnings for the tax year 2007–08 or any earlier tax year ("the relevant tax year") if the individual—
> (a) was UK resident in that year, but
> (b) was not domiciled in the UK, or was not ordinarily UK resident, in that year.
> (2) Section 22 or 26 of ITEPA 2003 (as amended by this Part of this Schedule) applies in relation to the general earnings as if—
> (a) section 809B of ITA 2007 (claim for remittance basis to apply) applied to the individual for the relevant tax year and
> (b) section 22(7) or 26(6) of ITEPA 2003 were omitted.

I think para 82(2)(b) is misconceived, though it does no harm. In practice the Courts will hold that non-CO earnings of an ordinarily resident foreign domiciled employee come into charge under s.15, notwithstanding the lack of the signpost in s.22(7).

12.3 Chargeable overseas earnings

The expression "chargeable overseas earnings" is a label which brings in two sets of requirements: the earnings must be "overseas earnings" and they must be "chargeable". The key part of the definition is "overseas earnings". Section 23(2) ITEPA provides the definition:

> General earnings for a tax year are "overseas earnings" for that year if—
> (a) section 809B, 809D or 809E of ITA 2007 (remittance basis)

applies to the employee for that year,
(aa) the employee is ordinarily UK resident in that year,
(b) the employment is with a foreign employer, and
(c) the duties of the employment are performed wholly outside the UK.

The concept of "chargeable" overseas earnings brings in the rules for deductible expenses (not discussed here) and associated employments.

12.3.1 *Transitional rule for pre-2008 earnings*

Suppose earnings accrue before 2008/09. At first sight the earnings cannot be "chargeable overseas earnings" within the definition of s.23(2) ITEPA since they do not meet the condition in s.23(2)(a): section 809B, 809D, or 809E did not apply before 2008/09. Moreover, para 82 which fills that gap in s.22 does not fill the gap in s.23. Construed strictly, therefore, pre-2008 earnings which were not remitted before 6 April 2008 have fallen out of charge!

However, I expect that the courts will to strive to construe the section avoid that result. After all, it is obvious (and para 82 confirms) that this result cannot have been intended. One way to do that is to say that if income arises before 2008, the question of whether it constitutes chargeable overseas earnings is to be decided by reference to the legislation in the year that it arises and not the legislation in the year that it is remitted. It has to be said that para 82 (3) sch 7 FA 2008 would then not be necessary. The alternative is to read para 82(2) as if it applied to s.23 as well as to s.22 and 26. Neither of these solutions is comfortable reading, but the conclusion that all pre-2008 earnings fall out of charge seems even worse. This is only one of many infelicities in schedule 7: but a modern court will strive to make it work.

12.4 Foreign employer

One requirement of "overseas earnings" is that the employment is with a "foreign employer". The definition is in s.721(1) ITEPA:

> "foreign employer" means an individual, partnership or body of persons resident outside the UK and not resident in the UK.

12.4.1 *Foreign employer: HMRC practice*

EI Manual para 40102 [April 2004] provides:

> An employee may maintain that general earnings are chargeable overseas earnings taxable on remittance under section 22 rather than on receipt ... This is likely to lead to a significant reduction in the amount of taxable earnings. You should examine the facts closely before accepting that earnings are chargeable overseas earnings within section 22. In particular you should find out whether the employer has any place of business in the UK. If you can trace an accounts file for the employer, ask the accounts Inspector for instructions on the employer's residence status.

12.5 Where are duties performed: incidental duties

The next requirement of "overseas earnings" is that "the duties of the employment are performed wholly outside the UK". Section 39 ITEPA elucidates this concept:

> **Duties in UK merely incidental to duties outside UK**
> (1) This section applies if in a tax year an employment is in substance one whose duties fall to be performed outside the UK.
> (2) Duties of the employment performed in the UK whose performance is merely incidental to the performance of duties outside the UK are to be treated for the purposes of this Chapter as performed outside the UK.

In other words, UK duties may be ignored if they are "merely incidental" to the performance of the other duties outside the UK. What are incidental duties? HMRC interpret this strictly. HMRC 6 provides:

> If your work is normally carried out abroad but you have to carry out some of your duties in the UK, the work you do in the UK will be part of your duties abroad only when you can show that the work you did in the UK was incidental to the duties of your employment abroad.
> Whether or not duties performed in the UK are incidental to an overseas employment will always depend on the circumstances of each particular case. Any decision has to be based on the work carried out in the UK – not the amount of time spent on it. But if you spend more than 91 days working in the UK in a tax year the work **will not** be incidental as it is

reasonable to say that someone who spends such an extended period working in the UK is actually working here rather than undertaking duties which are incidental to an overseas employment.

If the work you perform in the UK is the same or is of similar importance to the work that you do abroad, it will not be incidental. You will have to show that there is a purpose to the work you did in the UK which enabled you to do your normal work abroad and which you could only do in the UK.

Examples of work carried out in the UK as part of an overseas employment

Incidental work

• time spent in the UK by an overseas representative of a UK company to make reports or receive fresh instructions

• time spent training in the UK by an overseas employee which does not exceed 91 days in the tax year and provided no productive work is carried out in the UK by the trainee during that time

Non incidental work

• time spent in the UK as part of the duties of a member of the crew of a ship or aircraft

• attendance at director's meetings in the UK by a director of the company who normally works abroad.

Tax Bulletin 76 quotes from *Robson v Dixon* 48 TC 527 at p.534:

the words "merely incidental to" are ... apt to denote an activity (here the performance of duties) which does not serve any independent purpose but is carried out in order to further some other purpose.

EIM provides at para 40203 [June 2006]:

The case of *Robson v Dixon* (48 TC 527) involved a pilot, resident and ordinarily resident in the UK, who was employed by a Dutch airline. He flew aircraft from Amsterdam to various parts of the world. There were relatively few take-offs and landings in the UK [on average, seven per annum]. He claimed that the small number of take-offs and landings meant that his duties in this country were "merely incidental" to those performed abroad. The Courts rejected his claim on the grounds that the test is one of quality, not quantity. The Judge commented that the core duties of a pilot include landing and taking off in aircraft. So when the aeroplane landed in the UK the pilot was performing substantive duties of his employment.

Quality not quantity of duties

The case of *Robson v Dixon* established that it is the quality not the quantity of duties performed in the UK that determines whether or not they are "merely incidental". However, where the employee works in the UK for more than three months in a year, you should not accept that work can be "merely incidental".

Statement of Practice A10: airline pilots

Despite the decision in *Robson v Dixon* a single take off and landing in the UK in any year is disregarded on de minimis grounds in considering whether any duties are performed in this country.[3]

Dealing with cases

It is not possible to list "merely incidental" duties. Substantive and "merely incidental" duties are relative and specific to employments. It is important to obtain as much information about the employment and employee as possible. The following list of documents is not intended to be comprehensive:

- employment contract
- job description
- summary of main duties and responsibilities
- business diaries and travel details.

These may help but if at all possible arrange a meeting with the employee to obtain information first hand. Once you have a clear idea of the main duties you are in a position to take a view as to what are "merely incidental".

(This text has been withheld because of exemptions in the Freedom of Information Act 2000)

Some practical examples are set out at example EIM40204.

40204.

Employee resident, ordinarily resident or domiciled outside the UK: Location of duties: "merely incidental" duties: Examples

The following examples illustrate how particular situations should be treated.

Example 1

An overseas marketing executive of a UK employer spends the majority of each year working overseas. Visits to the UK total less than three months in a year. While in the UK the representative carries out the following duties:

- reports on trade conditions and results in the territory
- establishes questions of policy
- receives instructions
- collects samples in preparation for the next tour.

The duties performed in the UK should be regarded as "merely incidental". If the employee is not ordinarily resident the duties may be disregarded and the general earnings arising from them not charged under Section [15 ITEPA]. A charge may arise under Section 26 if the earnings are remitted here (see EIM40301).

Example 2

An overseas employee visits the UK for periods of training which do not exceed three months in the year. If no productive work is carried out while in the UK,

3 [Author's Note] In fact SP A10 states that a single take-off and landing is *normally* disregarded, but I am unable to think of a case where the normal practice should not be applied. So in the event of a mid-air emergency in the vicinity of the UK, the pilot can concentrate on the landing without worrying about UK tax–as long as he does not face two such emergencies in the same tax year.

the duties performed here are regarded as "merely incidental".

Example 3

The director of a limited company usually works abroad, but attends directors' meetings in the UK. That activity is basic to the joint duty of a board of directors to manage the company and therefore cannot be "merely incidental" to work done overseas.

Example 4

A courier for a tour operator visits many countries in the course of the employment. Visits to the UK, however few and however short, are of the same importance to the job as visits to other countries and therefore cannot be "merely incidental".

This approach is consistent with the 1955 Royal Commission which gave two examples of incidental duties: "returning for report" and "to collect samples, etc".[4]

Tax Bulletin 76 suggests that this will be the basis of an attack on dual contract arrangements:

> Given the way in which modern business operates and the ease and speed of communication, some employees may find it increasingly difficult to avoid performing substantive UK duties under their overseas contracts. For example, an employee who is responsible under their overseas contract for servicing the business of overseas clients may have to respond to a telephone call or e-mail from a worried overseas client with an urgent problem when the employee is in the UK. Formulating and communicating a response to such a problem would be regarded as a fundamental duty under the overseas contract. It follows that the performance of such duties in the UK will not be merely incidental to the performance of duties outside the UK as they will be of equal importance to the overseas duties. It is the quality of the UK duties and not the time devoted to their performance that determines whether they are merely incidental.

The Tax Bulletin goes on to reject a possible defence to this argument:

> **Overseas contracts and UK duties**
> Where the commercial reality shows the existence of separate employment contracts, it is sometimes argued that contractual terms that prohibit the performance in the UK of duties connected with the business of the overseas employer, preclude the Revenue from arguing

4 Cmd 9474 para 300.

> that the employee has performed duties of the overseas employment in the UK. These arguments are based on the UK duties being "ultra vires". We do not consider that the presence of such clauses means that we should ignore the performance of duties in the UK that clearly benefit the overseas employer. To that end, both employers ought to be closely monitoring the employee's UK activities. For example, where the employee has performed substantive duties in the UK that directly benefit the overseas employer, we would expect the UK employer to mark the fact that the employee is effectively abusing its time and take appropriate disciplinary action. And if the UK work in question was valuable, we would not expect the overseas employer to take it into account when calculating bonus entitlement. We think that clauses like this are frequently waived or ignored and may be inserted to create a misleading impression.

This is very doubtful.

12.6 Dual contract arrangements[5]

Tax Bulletin 76 (also classified as RI 273) explains this planning:

> The legislative scheme ... is advantageous to employees or office holders who can show that they are:
>
> - resident and ordinarily resident but not domiciled in the UK, and
> - perform duties of an office or employment under a foreign employer wholly outside the UK.
>
> As chargeable overseas earnings are taxed on remittance, there is a clear incentive to ensure that such earnings are paid overseas and to minimise the amount of earnings remitted to the UK. However, the requirement that the duties of the employment are performed wholly outside the UK presents problems to foreign domiciled employees whose jobs require them to work partly in the UK and partly abroad. Earnings from an employment with duties performed in and outside the UK would be taxable under section 21 wherever received. An employee may therefore be offered two employment contracts, for example:
>
> (1) covering the performance of duties in the UK, and
>
> (2) with an associated employer resident overseas, covering duties performed in the rest of the world, excluding the UK.

5 Alistair Ladkin has written a valuable article on this topic in *Taxation*, Vol. 150, No. 3900, p.632 (27 March 2003).

> The intention is that earnings from employment contract (2) will be chargeable overseas earnings and therefore taxable under section 22 only when remitted to the UK. For this reason, dual or multiple employment arrangements are popular with foreign domiciled employees whose duties are performed partly in the UK and partly outside the UK. The arrangement is generally that the individual enters into two separate written contracts, frequently referred to as the UK employment contract and the overseas employment contract.

Assuming the non-resident status of the employer and the non-domiciled status of the employee, HMRC can attack the planning in the following ways:

(1) Allege there is only one contract of employment (see below).
(2) Allege duties of the overseas employment are performed in the UK; see 12.5 (Where are duties performed: incidental duties).
(3) Apportionment arguments (see below).

12.6.1 *One contract of employment or two?*

Tax Bulletin 76 provides:

> **Inland Revenue response to dual contracts**
> Inland Revenue offices may make enquiries in order to check whether the earnings under the overseas contract are chargeable overseas earnings. They may also consider whether there is in fact a single employment contract notwithstanding the production of two written contracts. This approach has generally been deployed where there is concern that there has been an attempt to split a single employment to exploit the legislation that provides for chargeable overseas earnings to be taxed on remittance.
> Employers, employees and their advisers maintain that there are separate and distinct employments. They invariably argue that the employee performs a different role with different responsibilities under each contract of employment and that the duties under each do not overlap and are not dependent on each other. In many cases written contracts have been drafted that fairly represent the true employment relationships and include a proper job description along with details of the remuneration package and other entitlements (annual leave etc) relating to each employment. Care has been taken to ensure that the roles described in each contract are capable of independent existence with

> proper regard given to what would happen on termination of one of the employments. Best practice has recognised the importance of maintaining separate payroll and expenses regimes and different line management and reporting arrangements.
> Where there are two employment contracts and the written contracts reflect this, dual contract arrangements provide a legitimate way to structure an individual's employment relationships. Where the Revenue is satisfied that the arrangements reflect the true employment relationships, enquiries focus on:
> - whether the employee has in fact performed substantive duties under the overseas contract in the UK,
> - whether a section 24 adjustment is needed to address an imbalance between the earnings from the UK and overseas contracts.

The Tax Bulletin continues:

> **Tax impact where dual contract arrangements fail**
> Where the facts indicate that there is, in commercial reality, only one employment contract whereby the employee performs duties for the benefit of one employer both in and outside the UK, all of the employee's general earnings will be taxable under section 21 ITEPA. As earnings attributable to overseas duties will not be chargeable overseas earnings, tax will be charged on receipt rather than on remittance to the UK. The identity of the "employer" will depend on all the facts and circumstances of the individual case.

As a matter of contract law, I think this is wrong. If the drafting is correct, there will be two separate contracts. The fact that on HMRC analysis it is unclear who is the employer suggests there must be something wrong with it.[6] The conclusion can be defended on the basis of *IRC v Scottish*

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6 The 1955 Royal Commission considered that dual contract arrangements would work. Report Cmd 9474 para 305 provides:

> "(3) Let the resident be taxed— ...
> *(c)* on the apportioned basis, if he is domiciled outside the UK, in respect of income from an employment which is performed partly inside and partly outside the UK, the part of his income attributed to the work performed outside the UK being itself taxed on the remittance basis;
> *(d)* on the whole income, if he is domiciled in the UK, in respect of income from an employment which is performed partly inside and partly outside the UK.
>
> 306. The reason for the special treatment of the non-domiciled resident is that

Provident Institution 76 TC 538: the two contracts being regarded as one composite contract for tax purposes, even though they are (if the drafting is right) separate contracts as a matter of contract law.

The Tax Bulletin then turns to PAYE:

> However, the UK entity that receives the benefit of an individual's services will be obliged to apply PAYE to all payments of PAYE income made to the employee during the period that the employee works for that entity. This is because the UK entity will either be the employer or (for the purposes of section 689 ITEPA) the relevant person.
>
> If there are genuine separate employments but the employee has performed substantive duties in the UK for the overseas employer, then all earnings from the overseas contract will be taxable under section 21 in the relevant year. They will not qualify as chargeable overseas earnings under section 22 because the duties of employment with a foreign employer will not have been performed wholly outside the UK in the year in question. There is unlikely to be an obligation to operate PAYE on earnings from the foreign employer, as that employer will not have the necessary presence in the UK for PAYE purposes, and the UK employer will not be the relevant person in relation to duties performed by the employee under the separate overseas employment.

The Bulletin concludes with a comment on NIC:

> **National Insurance**
>
> [1] Where for tax purposes the facts indicate that despite the existence of two written employment contracts, there is a single employment covering UK and overseas duties, there could also be National Insurance consequences.
>
> [2] If it is found that the earnings relating to overseas duties are

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the person most likely to be affected is the employee of a foreign concern who makes his home and headquarters in the UK, while his duties include a good deal of work in Europe. It seems fair to treat his 'European' earnings as if they were truly foreign income, and it is probably to the advantage of this country to recognise the special case. *Even if it did not, most of such employees could get into an equivalent position by having two separate contracts of service, one providing for UK duties and remuneration and the other for European duties and remuneration, in which event the latter income would be taxed on the remittance basis as at present.*"
(Emphasis added)

attributable to employment with the UK employer, there will be liability to pay further National Insurance.

Point [1] is tentatively expressed; the Bulletin wisely does not try to grapple with the complexities of NIC.[7]

12.6.2 *Apportionment*

Section 24 ITEPA prevents an over-generous attribution of income to the foreign contract:

> **Limit on chargeable overseas earnings where duties of associated employment performed in UK**
>
> (1) This section imposes a limit on how much of an employee's general earnings are chargeable overseas earnings for a tax year under section 23 if—
>
> (a) in that year the employee holds associated employments as well as the employment to which subsection (2) of that section applies ("the relevant employment"), and
>
> (b) the duties of the associated employments are not performed wholly outside the UK.
>
> (2) The limit is the proportion of the aggregate earnings for that year from all the employments concerned that is reasonable having regard to—
>
> (a) the nature of and time devoted to each of the following—
>
> (i) the duties performed outside the UK, and
>
> (ii) those performed in the UK, and
>
> (b) all other relevant circumstances.
>
> (3) For the purposes of subsection (2) "the aggregate earnings for a year from all the employments concerned" means the amount produced by aggregating the full amount of earnings from each of those employments for the year mentioned in subsection (1) so far as remaining after subtracting any amounts of the kind mentioned in step 2 in section 23(3).
>
> (4) In this section—
>
> (a) "the employments concerned" means the relevant employment and the associated employments;
>
> (b) "associated employments" means employments with the same employer or with associated employers.
>
> (5) The following rules apply to determine whether employers are associated—
>
> *Rule A* An individual is associated with a partnership or company if that individual has control of the partnership or company.
>
> *Rule B* A partnership is associated with another partnership or with a company if one has control of the other or both are under the control of the same person or persons.

7 See 35.1 (National insurance contributions).

Rule C A company is associated with another company if one has control of the other or both are under the control of the same person or persons.

(6) In subsection (5)—

(a) in rules A and B "control" has the meaning given by section 995 of ITA (in accordance with section 719 of this Act), and

(b) in rule C "control" means control within the meaning of section 416 of ICTA (meaning of expressions relating to close companies).

(7) If an amount of chargeable overseas earnings is reduced under step 3 in section 23(3) as a result of applying any limit imposed by this section, the amount of general earnings corresponding to the reduction remains an amount of general earnings within section 15(1).

12.6.3 *Implications for employer*

Inspectors Manual para 5348 provided:

> Apart from the Schedule E implications there are other questions to consider:-
> [1] Is the cost of remunerating the individual under his contract for overseas duties effectively borne by a UK company and claimed as a deduction in computing profits which are chargeable to Corporation Tax? If so, there is a mismatch which will need to be considered with some care.
> [2] Do the individual's activities under the contract for overseas duties generate income, and if so to whom does it accrue? Is income which would otherwise accrue to a company which is liable to Corporation Tax being routed to an overseas company?
> [3] If the profits of a company which is liable to Corporation Tax are computed on a cost plus basis are the costs being depressed by reason of the split employment?

Point [1] raises deductibility issues; point [2] raises Controlled Foreign Company issues; point [3] raises transfer pricing issues. All these should be considered before entering into dual contract arrangements.

12.6.4 *Disclosure requirements*

HMRC say:

> We can confirm again that we do not intend promoters or employers to have to disclose everyday advice and arrangements. In the context of

> employment products this would include ... standard dual contract arrangements (although we will require disclosure of innovative arrangements).[8]

This statement was made before the Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regs 2006, but it is still valid under the current law. It is interesting that the statement describes dual contract arrangements as "everyday" and "standard".

12.7 Resident but not ordinarily resident employee

Section 26 ITEPA provides:

> **26 Foreign earnings for year when remittance basis applies and employee not ordinarily UK resident**
> (1) This section applies to general earnings for a tax year where section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the employee for that year and the employee is not ordinarily UK resident in that year, if the general earnings are neither—
> (a) general earnings in respect of duties performed in the UK, nor
> (b) general earnings from overseas Crown employment subject to UK tax.[9]
> (2) The full amount of any general earnings within subsection (1) which are remitted to the UK in a tax year is an amount of "taxable earnings" from the employment in that year.
> (3) Subsection (2) applies whether or not the employment is held when the earnings are remitted. ...
> (5) See Chapter A1 of Part 14 of ITA 2007 for the meaning of "remitted to the UK" etc.
> (6) General earnings for the employee for the tax year fall within section 15(1) if they do not fall within subsection (1).

In short, a resident non ordinarily resident remittance basis taxpayer pays tax::

(1) on an arising basis on general earnings in respect of duties performed in the UK; and

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8 Statement to CIOT accessible *www.tax.org.uk/showarticle.pl?id=2704*.
9 See 12.18 (Overseas Crown employment).

(2) on a remittance basis on other earnings.

This is better than the remittance basis for UK resident and ordinarily resident foreign domiciliary:

(1) It is not necessary to have a foreign employer.
(2) It is not necessary that duties are performed *wholly* outside the UK. (So it is not necessary to consider dual contract arrangements.)

Much of the wording of s.26 is the same as s.22 ITEPA, and so the reader is referred back to 12.2 (Resident, ordinarily resident and foreign domiciled employee).

12.8 Non-resident employee

Section 27 ITEPA provides:

> **UK-based earnings for year when employee not resident in UK**
> (1) This section applies to general earnings for a tax year in which the employee is not resident in the UK if they are—
> (a) general earnings in respect of duties performed in the UK, or
> (b) general earnings from overseas Crown employment subject to UK tax.
> (2) The full amount of any general earnings within subsection (1) which are received in a tax year is an amount of "taxable earnings" from the employment in that year.
> (3) Subsection (2) applies whether or not the employment is held when the earnings are received.

This applies regardless of domicile. DTTs often override the charge to UK tax.

12.9 "Duties performed in the UK"

The concept of "duties performed in the UK" is relevant for:

(1) A resident but non-ordinarily resident employee, where it makes the difference between an arising and a remittance basis.
(2) A non-resident employee, where it makes the difference between taxable income and tax-free income.

Section 38 ITEPA elucidates the concept:

> **Earnings for period of absence from employment**
> (1) This section applies if a person ordinarily performs the whole or part of the duties of an employment in the UK.
> (2) General earnings for a period of absence from the employment are to be treated for the purposes of this Chapter as general earnings for[10] duties performed in the UK except in so far as they would, but for that absence, have been general earnings for duties performed outside the UK.[11]

EIM para 40202 provides:

> If an employee who ordinarily works in the UK is absent from work, the general earnings for the period of absence must be treated as being for duties performed in the UK, even if the employee is in fact abroad at that time. If, exceptionally, the employee can show that if he had been working, the earnings would have been for working abroad then this rule is not applied.
> *Example*
> An employee who is not ordinarily resident in the UK performs the duties of the employment in Manchester. Illness meant that a holiday in Florida was unexpectedly extended so the days normally spent in the UK were lost. The Inspector received a calculation of earnings chargeable under s.[15 ITEPA][12] that excluded salary attributable to the days of absence.
> The Inspector successfully contended that Section 38 [ITEPA] applied on the basis that the duties of the employment were normally performed in the UK. The earnings that had been excluded were therefore UK-based earnings within s.[15 ITEPA]

10 S.38 refers to earnings "for" duties performed in the UK, whereas ss.26, 27 ITEPA refer to earnings "in respect of" duties performed in the UK, but the meaning must be the same.

11 Special rules apply for:
(1) duties on board vessels or aircraft: s.40 ITEPA;
(2) duties performed in the UK sector of the Continental Shelf: s.41 ITEPA.

12 The reference from 2008/2009 is now s.26 ITEPA.

12.10 Earnings "in respect of" duties performed in the UK

SP 1/09 provides:

> 12. Employees who are resident but not ordinarily resident in the UK are chargeable to UK tax under Section 15 ITEPA on general earnings wherever received for duties performed in the UK. They are also chargeable under Section 26 ITEPA on general earnings for duties performed outside the UK but only to the extent that the earnings are remitted to the UK.
> 13. Where the duties of a single office or employment are performed both in and outside the UK, an apportionment is required to determine how much of the general earnings are attributable to the UK duties. Apportionment of general earnings is essentially a question of fact, but for many years HMRC has accepted time apportionment, based on the number of days worked abroad and in the UK, except where this would clearly be inappropriate. For example, in the case of an employee with 200 working days in the UK and 50 working days outside the UK, the proportion of general earnings attributable to UK duties would be 200/250. This practice does not, of course, apply where the charge arises under Section 15 ITEPA and relief is due under Part 5 Chapter 6 ITEPA (Deductions from seafarers' earnings).

Time apportionment would be inappropriate if there are different rates of pay in the two places of work, but the employee will need to provide evidence of this. In *Perro v Mansworth* [2001] STD (STC) 179 payment under a tax equalisation scheme relating to UK tax was held to be a payment of earnings in respect of duties performed in the UK. See too *Varnam v Deeble* 58 TC 501; *Brown v Platten* 59 TC 408; *Coxon v Williams* 60 TC 659; Tax Bulletin 62.

12.11 Remittance after year for which earnings are paid

The charge on the remittance basis applies whether the earnings are for that year or for some other tax year.

12.12 Remittance after employment ceases

The charge on the remittance basis applies "whether or not the employment is held at the time when the earnings are remitted": ss.22(3) and 26(3)

ITEPA.

12.13 Earnings of non-UK resident

To be "overseas earnings" the earnings must be for a year of assessment in which the employee was resident and ordinarily resident in the UK. Accordingly, any earnings for a year during which the employee was not UK resident can be remitted at any time without any charge to tax. The concept of earnings "for" a year is explained in s.29 ITEPA.

12.14 Remittance after death of employee

The drafter has also provided for this case. If PRs receive chargeable overseas earnings in the UK, there is a tax charge on them. Section 13(4) ITEPA provides:

> If the tax is on general earnings received, or remitted to the UK, after the death of the person to whose employment the earnings relate, the person's personal representatives are liable for the tax.

If they receive emoluments out of the UK and assent to beneficiaries, there is no charge.

12.15 Remittance from earnings for mixed UK/foreign duties

12.15.1 *The statutory position from 2008/09*

This section considers the position where:

(1) an employee who is a remittance basis taxpayer, and who is resident but not ordinarily resident, receives earnings for duties which are performed partly in and partly out of the UK.
(2) The earnings are received abroad.

The earnings are taxed partly on an arising basis and partly on the remittance basis, and the earnings received constitute a mixed fund consisting of what I will call (1) taxed UK earnings and (2) untaxed foreign earnings.

The statutory position is (in short) taxed UK earnings (mixed fund category (a)) is remitted before untaxed foreign earnings (mixed fund category (b)), but later years earnings are taxed before earlier years. So employees would need to keep each year's earnings in separate accounts and never remit more than the taxed income in the account at any one time.

12.15.2 *HMRC practice in 2008/09*

SP 5/84 paras 1 & 2 summarised the taxation of earnings for a resident non-ordinarily resident individual. The SP then explains the practice before 1983:

> 3 Where an employee resident but not ordinarily resident in the UK performs the duties of a single office or employment both in and outside the UK and is remunerated wholly abroad, he is permitted, by a broad interpretation of the decision in the case of *Sterling Trust Ltd v IRC* 12 TC 868, to say that any remittances made to the UK are made primarily out of general earnings for that year in respect of duties performed in the UK assessable under [s.15 ITEPA], and only any alance out of general earnings chargeable under s.26 on remittance.[13]

> 4 However, where part of the general earnings are remitted to the UK, it has been the practice of the Revenue to regard the proportion of the earnings remitted to the UK, as in respect of duties performed both in and outside the UK, and to treat that proportion of such earnings as is attributable to duties performed outside the UK as remitted to the UK for the purposes of s.26.

I find this difficult to follow (paras 3 and 4 do not seem consistent) but it does not matter because the practice changed in 1983:

> 5 The practice changed with effect from 6 April 1983 when the Revenue introduced a simplified procedure for employees who—
> (a) are resident but not ordinarily resident in the UK;
> (b) perform duties of a single employment both in and outside the UK, so that they are potentially chargeable under both ITEPA ss.[15] and 26, in respect of general earnings from that employment; and

13 [Author's Note] This is arguably correct in law and not a concession: see 9.33 (Remittance from mixture of taxed and untaxed income).

(c) receive part of their general earnings in the UK and part abroad. In such cases, provided the general earnings chargeable under s.[15] are arrived at in a reasonable manner (ie in the absence of special facts, the proportion of the general earnings, including benefits in kind, relating to UK duties is arrived at on a time basis by reference to working days), the Revenue are prepared to accept that a charge under s.26 will arise only where the aggregate of general earnings remitted to the UK exceeds the amount chargeable under s.[15] for that year; and to restrict the charge under s.26 to the excess of the aggregate over the charge under s.[15].

This continues to apply in 2008/09, by concession. The RDR Manual provides:

For 2008-09 tax year only HMRC will continue to operate Statement of Practice 5/84 on the same basis as in 2007-08. The statement of practice will operate on a concessionary basis until the end of the tax year 2008-09 and where appropriate apply instead of provisions in Schedule 7 Finance Act 2008 (for example instead of the mixed fund rule). This temporary measure is intended [to] help ensure a smooth transition to the new legislation in 2008-09 for employers and employees who use the statement of practice.

12.15.3 *Position from 2009/10*

SP 1/09 provides:

Transfers made from an offshore account holding only the income or gains relating to a single employment
4. Sections 809Q ITA onwards set out rules to determine the kinds and amount of income or chargeable gains remitted to the UK from a fund containing more than one kind of income and capital, or income, or capital of more than one tax year. Such a fund is defined in sections 809Q and 809R as a "mixed fund". Where amounts are transferred to the UK out of a mixed fund, Section 809Q(3) requires that the individual's tax liability is calculated by reference to each individual transfer. This transfer by transfer approach is referred to below as the "mixed fund rule". This is a change to HMRC's previous practice, with respect to employees to whom SP 5/84 applied, which was to allow the tax liability to be calculated by reference to the total amount transferred to the UK during the tax year as a whole.
5. In the circumstances outlined in this statement of practice, HMRC will

accept that certain individuals who are resident but not ordinarily resident in the UK do not have to apply the mixed fund rule and can continue to calculate their tax liability by reference to the total amount transferred out of a mixed fund during the tax year as a whole, rather than by reference to individual transfers.

12.15.4 *Accounts qualifying for the concession*

Only certain accounts qualify for the concessionary treatment in the SP:

> 6. Employees who are resident but not ordinarily resident in the UK and who perform duties of an office or employment both inside and outside the UK, do not have to apply the mixed fund rule in respect of transfers from a particular account where:
> [1] The mixed fund is an account held solely by the employee; and
> [2] The account only contains employment income from a single employment plus:
> [a] Any interest arising only on that account, and
> [b] Any gains arising from foreign exchange transactions in respect of the funds in that account
> [c] Any gains arising on employee share scheme related transactions
> [d] Any proceeds from employee share scheme related transactions, not otherwise covered at paragraph 7, in respect of amounts paid by the employee in acquiring the shares.
> 7. The employment income from that employment may include:
> [1] Employment income (subsection 809Q(4)(a));
> [2] Relevant foreign earnings (subsection 809Q(4)(b));
> [3] Foreign specific employment income (including termination payments and the proceeds from employee share schemes) (subsection 809Q(4)(c)), and
> [4] Employment income subject to a foreign tax (subsection 809Q(4)(f)).

Take care not to pay any dividend income into the account!

12.15.5 *The concessions*

SP 1/09 contains two concessions. Firstly::

> 8. Employees who are resident but not ordinarily resident in the UK may also choose not to apply the mixed fund rule if the account contains only income or gains of a kind listed at paragraphs 6 and 7 above, but for more than one tax year. Where this is the case, the ordering rules at section

809Q(3) shall be applied—ie on a last in first out basis.
9. Where the employee applies this statement of practice, amounts transferred out of the account to the UK will be treated as comprising the kinds of income and gains in the order set out in section 809Q(4) for the tax year as a whole.

The SP then repeats a point made in para 6:

10. Accounts containing income or gains of more than one employment are not covered by this statement of practice.
11. Accounts containing income or gains of more than one individual are not covered by this statement of practice.

After a comment on apportionment (set out above) the SP then provides:

14. Where an employee resident but not ordinarily resident in the UK performs the duties of a single office or employment both in and outside the UK and is remunerated wholly abroad, he is permitted, by a broad interpretation of the decision in the case of *Sterling Trust Ltd v IRC* (12 TC 868), to say that any remittances made to the UK are made primarily out of general earnings for that year in respect of duties performed in the UK assessable under Section 15, and only any balance out of general earnings chargeable under Section 26 on remittance.

This text is copied from SP 5/84 though *Sterling Trust* cannot have any relevance to the ITA remittance basis.

15. However, where part of the general earnings are remitted to the UK, it was the practice of HMRC to regard the proportion of the earnings remitted to the UK, as being in respect of duties performed both in and outside the UK, and to treat that proportion of such earnings as were attributable to duties performed outside the UK as remitted to the UK for the purposes of Section 26.
16. The practice changed with effect from 6 April 1983 when HMRC introduced a simplified procedure for employees who:
– are resident but not ordinarily resident in the UK;
– perform duties of a single employment both in and outside the UK, so that they are potentially chargeable under both Sections 15 and 26 ITEPA 2003 in respect of general earnings from that employment; and
– receive part of their general earnings in the UK and part abroad.
17. In such cases, provided the general earnings chargeable under Section 15 are arrived at in a reasonable manner (ie in the absence of special

> facts, the proportion of the general earnings, including benefits in kind, relating to UK duties is arrived at on a time basis by reference to working days), HMRC is prepared to accept that a charge under Section 26 will arise only where the aggregate of general earnings remitted to the UK exceeds the amount chargeable under Section 15 for that year; and to restrict the charge under Section 26 to the excess of the aggregate over the charge under Section 15.

This text is also repeated from SP 5/84 (the comment on the pre-1983 position is of no relevance now.)

SP 1/09 is classified as a statement of practice (though it is clearly a concession). This is presumably because HMRC are not now supposed to grant concessions (except for minor and transitional matters). BN55 (22 April 2009) suggests that the Government have realised that the SP is an unsatisfactory stop-gap measure:

> The Government will legislate Statement of Practice 1/09 in Finance Bill 2010, to allow for a period of consultation with external stakeholders on the most effective way of doing so.

12.16 Earnings from Ireland

In the following discussion:

"Irish earnings" means earnings from an Irish resident employer; it is assumed that the conditions for the remittance basis are in principle all met (duties performed outside the UK, etc etc).

"Pre-2008 earnings" means earnings arising before 6 April 2008.

The UK/Ireland DTT also needs to be considered but it is not discussed here. Similar points arise in relation to RFI; see 9.23 (RFI from Ireland).

12.16.1 *Earnings from 2008/09*

The position for earnings from 2008/09 is straightforward. The ITA remittance basis treats Irish earnings in the same way as any other foreign earnings. The FA 2008 repealed the rule of the pre-2008 remittance basis which provided (unlawfully and probably ineffectively) that Irish earnings were taxed on an arising basis.

12.16.2 *Pre-2008 earnings remitted from 2008/09*

This change raised the problem of transition. Para 82 Sch 7 FA 2008 provides:

> (1) This paragraph applies in relation to an individual's general earnings for the tax year 2007–08 or any earlier tax year ("the relevant tax year") if the individual—
> (a) was UK resident in that year, but
> (b) was not domiciled in the UK, or was not ordinarily UK resident, in that year...
> (3) In relation to the general earnings, the definition of "foreign employer" in section 721(1) of ITEPA 2003 has effect as if at the end there were inserted "and not resident in the Republic of Ireland".

Amended as para 82(3) directs, s.721(1) ITEPA provides:

> "foreign employer" means an individual, partnership or body of persons resident outside the UK and not resident in the UK *and not resident in the Republic of Ireland*.

Thus (although this might surprise the residents of Eire) an Irish resident employer is not (for this purpose) a "foreign employer" so pre-2008 Irish earnings are not "chargeable overseas earnings" so the remittance basis does not apply to them. Para 82(3) is simply a roundabout way of disapplying the remittance basis charge for pre-2008 Irish earnings.
EN FB 2008 provides:

> 395. Subsection (3) ensures that the existing restriction on the application of the remittance basis in the case of employment income from employers resident in the Republic of Ireland continues to apply in relation to the remittance on or after 6 April 2008 of general earnings arising before that date. This will prevent double taxation as the general earnings have already been taxed when they arose.

In short, if:

(1) Irish earnings arose before 2008/09; and
(2) The earnings are remitted on or after 2008/09

there is no tax charge on remittance.

12.16.3 *Why is para 82(3) needed?*

Before 2008, s.721 ITEPA provided:

> *foreign employer" means*
> *(a) in the case of an employee resident in the UK, an individual, partnership or body of persons resident outside the UK and not resident in the UK* ***or the Republic of Ireland,***

Under this definition, earnings from an Irish resident employer could not have been chargeable overseas earnings so at first it seems that para 82(3) is not needed. It may be that para 82(3) is otiose; it is inserted by mistaken analogy with para 83(3) (which is needed). However para 82(3) is needed on the assumption that where

(1) earnings arose before 2008/09 and
(2) the earnings are remitted from or after 2008/09

the question of whether the earnings qualify as chargeable overseas earnings is to be determined by the legislation as it stands in the year of remittance, and not by the legislation as it stood at the time that the earnings arose.

12.16.4 *Pre-2008 Irish earnings: tax position before 2008/09*

As noted above, according to statute, the remittance basis did not apply if the employer was resident in the Republic of Ireland: pre-2008 Irish earnings were taxable on the arising basis and not the remittance basis. The discrimination against Ireland was contrary to EU law.[14] This work advised that those with pre-2008 Irish earnings should only agree to pay tax on the remittance basis. Where tax has been paid on an arising basis which would not have been paid on a remittance basis, a repayment claim should be made.[15] Under para 82(3) discussed above, pre 2008 Irish source

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14 The point was discussed in some detail in the 6th edition of this book para 9.51 and 10.4.2.

15 For the limitation period see s.106 FA 2007.

income which was not remitted before 2008/09 escapes UK tax altogether, since unremitted Irish source income was not lawfully taxable when it arose and it is not (from 2008/09) taxable on remittance. I expect that this will not often arise in practice, but occasionally it may be important.

12.17 Foreign service exemption for termination payments

When a foreign domiciliary comes to the UK having worked for an overseas employer for a number of years, he may receive a termination payment after his arrival in this country. This would ordinarily be chargeable as employment income by s.403 ITEPA to the extent that it exceeds £30,000. However, s.413 ITEPA provides a territorial exemption.

A payment satisfying the above conditions can be remitted free of income tax to the UK. It is a moot point why the payment does not give rise to CGT, but in practice HMRC do not take that point.

12.18 Overseas Crown employment

General earnings from overseas Crown employment subject to UK tax[16] are taxed on an arising basis, regardless of residence, domicile and place of work. In the case of UK resident and ordinarily resident employees, such earnings are charged in the normal way under s.15 ITEPA and excluded from the remittance basis because the Crown is not a foreign employer. In the case of a UK resident and non-ordinarily resident individual, the earnings are charged in the normal way under s.15 and excluded from the remittance basis by s.26(1)(b) ITEPA.[17] In the case of a non-resident employee, the charge is under s.27 ITEPA.[18] The 1955 Royal Commission Report explains the reason:

> International comity does not permit the salary of the servant of one State to be taxed by another State: consequently a Crown servant, even if spending his whole time on work abroad, is not amenable to the local taxing jurisdiction and, if he is to be taxed at all, must be taxed by the UK taxing authority. No doubt the scale of remuneration for Crown

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16 The expression "general earnings from overseas Crown employment subject to UK tax" is defined in s.28 ITEPA.

17 See 483 (Resident but not ordinarily resident employee).

18 See 12.8 (Non-resident employee).

servants abroad is fixed with these considerations in mind.[19]

12.19 Seafarers

The rules relating to seafarers and duties performed on vessels and aircraft are too specialist to be considered here, but reference should be made to s.39(3) and ss.40, 372 and Chapter 6 Part 5 ITEPA. On residence of seafarers, see 3.16 (Seafarers and nomads).

12.20 Lower-paid employee exemption

BN55 (22 April 2009) provides:

> Individuals with small amounts of foreign employment income
> 5. Individuals employed in the UK are currently required to file a Self Assessment tax return if they have also received income from overseas employment in the same tax year. This is the case even where there is little or no tax to pay in the UK because the overseas employment income has already been subject to tax in the other country.
> 6. This obligation to file a return will be removed with effect from 6 April 2008 where such individuals have overseas employment income of less than £10,000 and overseas bank interest of less than £100 in any tax year, all of which is subject to a foreign tax.

EN FB 2009 provides:

> 11. This clause introduces a new income tax exemption for low-income employees working in the UK who meet certain conditions. Such individuals will typically be migrant workers employed in seasonal work in the agricultural or service sectors in UK and in other countries in the same tax year and whose overseas income is subject to tax where it is earned. Previously they were required to file a Self Assessment tax return, even in situations where there was no, or very little, tax to pay. This exemption removes that requirement in most cases.

According, s.828A ITA provides:

19 Cmd 9474 para 307.

Chapter 1A
Exemption for Persons Not Domiciled in UK
828A Introduction
This Chapter provides for an exemption from liability to income tax for an individual for a tax year if.
(a) the individual is UK resident in the tax year but not domiciled in the UK in the tax year,
(b) section 809B does not apply to the individual for the tax year, and
(c) conditions A to F in section 828B are met.

I refer to these as "**LPE conditions A to F"** to avoid confusion with the myriad other conditions in ITA.

12.20.1 *LPE condition A: UK employment*

Section 828B(1) ITA provides:

Condition A is that in the tax year the individual has income from an employment the duties of which are performed wholly or partly in the UK.

Section 828D ITA defines "employment":

(1) This section applies for the purposes of this Chapter.
(2) "Employed" and "employment" have the same meaning as in the employment income Parts of ITEPA 2003: see Chapter 1 of Part 2 of that Act.

If these were income-tax wide definitions it would not be necessary to say this here.

12.20.2 *LPE condition B: cap on RFE*

Section 828B(2) ITA provides:

Condition B is that, if the individual's income for the tax year consists of or includes relevant foreign earnings—
(a) the amount of the relevant foreign earnings does not exceed £10,000, and
(b) all of that amount is subject to a foreign tax.

Section 828D(5) defines "relevant foreign earnings":

> "Relevant foreign earnings", in relation to an individual, means what would be the individual's relevant foreign earnings for the purposes of Chapter A1 of this Part if section 809B applied to the individual (see section 809Z7(3)).

Section 828D(4) ITA defines "foreign tax":

> "Foreign tax" means any tax chargeable under the law of a territory outside the UK.

12.20.3 *LPE condition C: cap on RFI*

Section 828B(3) ITA provides:

> Condition C is that, if the individual's income for the tax year consists of or includes income that is relevant foreign income by virtue of section 830(2)(e) of ITTOIA 2005—
> (a) the amount of that income does not exceed £100, and
> (b) all of that amount is subject to a foreign tax.

In order to understand the reference to s.830(2)(e) ITTOIA one needs to read it together with s.830(1):

> (1) In this Act "relevant foreign income" means income which—
> (a) arises from a source outside the UK, and
> (b) is chargeable under any of the provisions specified in subsection (2) (or would be so chargeable if section 832 did not apply to it).
> (2) The provisions are ...
> (e) Chapter 2 of Part 4 (interest),

12.20.4 *LPE condition D: no other income/gain*s

Section 828B(4) ITA provides:

> Condition D is that the individual has no other foreign income and gains for the tax year.

Section 828D(3) ITA defines "foreign income and gains":

> "Foreign income and gains", in relation to an individual, means what would be the individual's foreign income and gains for the purposes of Chapter A1 of this Part if section 809B applied to the individual (see section 809Z7(2)).

12.20.5 *LPE condition E: exclusion of higher rate taxpayers*

Section 828B(5) ITA provides:

> Condition E is that the individual would not for the tax year be liable to income tax at a rate other than the basic rate or the starting rate for savings if this Chapter did not apply to the individual for the tax year.

12.20.6 *LPE condition F: no tax return*

Section 828B(6) ITA provides:

> Condition F is that the individual does not make a return under section 8 of TMA 1970 for the tax year.

Since a return is due, if HMRC require it, the position is that HMRC have a power to withdraw the exemption (by requiring a return). The rule is thus: no tax is due unless HMRC happen to ask for it. This is a new development in tax policy; one hopes it does not become standard.

12.20.7 *The exemption*

Section 828C ITA provides:

> (1) The exemption is given by deducting the relevant amount from what would otherwise be the amount of the individual's liability to income tax for the tax year under section 23.
> (2) "The relevant amount" is so much of the amount of the individual's liability to income tax as is attributable to the individual's foreign income or gains for the tax year.

12.20.8 *Restriction on exemption*

Section 828C ITA provides:

> (3) But if for the tax year the individual's total income is reduced by any deductions which fall to be made at Step 3 of the calculation in section 23 from the individual's foreign income or gains for the tax year, subsection (2) has effect as if the individual's foreign income or gains for the tax year were reduced by the amount of the deductions.
> (4) And if the individual is entitled under.
> (a) section 788 of ICTA (double taxation arrangements: relief by agreement), or
> (b) section 790(1) of that Act (relief for foreign tax where no double taxation arrangements),
> to a tax reduction in respect of the individual's foreign income or gains for the tax year, what would otherwise be the relevant amount is reduced by the amount of that reduction.

12.21 PAYE

Section 690 ITEPA modifies the PAYE rules for non-resident or NOR employees on the remittance basis:

> (1) This section applies in relation to an employee in a tax year only if the employee—
> (a) is not resident or, if resident, not ordinarily resident in the UK, and
> (b) works or will work in the UK and also works or is likely to work outside the UK.
> (2) If in relation to an employee to whom this section applies and any tax year it appears to an officer of Revenue and Customs that—
> (a) some of the income paid to the employee by the employer[20] is PAYE income, but
> (b) some of that income may not be PAYE income,
> an officer of Revenue and Customs may, on an application made by

20 Section 690(3)(b) ITEPA provides:
(b) any reference to a payment made by the employer includes a reference to a payment made by a person acting on behalf of the employer and at the expense of the employer or a person connected with the employer.

the appropriate person,[21] give a direction for determining a proportion of any payment made in that year of, or on account of, income of the employee which is to be treated as PAYE income.
(2A) For the purposes of subsection (2) as it applies in relation to an employee who is UK resident but not ordinarily UK resident in a tax year, the officer may treat section 809B of ITA 2007 (remittance basis) as applying to the employee for that year, even if no claim under that section has been made.[22]

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21 Section 690(3)(a) defines "appropriate person":
In this section—
(a) "the appropriate person" means the person designated by the employer for the purposes of this section and, if no person is so designated, the employer...

22 For completeness, the section continues:
(4) An application under subsection (2) must provide such information as is available and is relevant to the application.
(5) A direction under subsection (2)—
(a) must specify the employee to whom and the tax year to which it relates,
(b) must be given by notice to the appropriate person, and
(c) may be withdrawn by notice to the appropriate person from a date specified in the notice.
(6) The date so specified may not be earlier than 30 days from the date on which the notice of withdrawal is given.
(7) If—
(a) a direction under subsection (2) has effect in relation to an employee to whom this section applies, and
(b) a payment of, or on account of, the income of the employee is made by the employer in the tax year to which the direction relates,
the proportion of the payment determined in accordance with the direction is to be treated for the purposes of PAYE regulations as a payment of PAYE income of the employee.
(8) If in any tax year—
(a) no direction under subsection (2) has effect in relation to an employee to whom this section applies, and
(b) any payment of, or on account of, the income of the employee is made by the employer,
the entire payment is to be treated for the purposes of PAYE regulations as a payment of PAYE income of the employee.
(9) Subsections (7) and (8) are without prejudice to—
(a) any assessment in respect of the income of the employee in question, and
(b) any right to repayment of income tax overpaid and any obligation to pay income tax underpaid.
(10) In a case where section 689 applies—
(a) the references to the employer in subsection (3)(a) are to be read as references to the relevant person, and

HMRC brief 17/09 provides:

> **Section 690 ITEPA directions**
> Prior to April 2008 non-domiciled individuals and not ordinarily resident individuals were automatically taxed on the remittance basis on their foreign employment income. However since April 2008 individuals have to make an annual claim to the remittance basis. Section 690 ITEPA was amended in Finance Act 2008 to reflect this change for not ordinarily resident employees. Prior to April 2008 employers were able to ask for a section 690 direction which permitted them not to apply PAYE to certain employment income paid to not ordinarily resident employees entitled to be taxed on the remittance basis. These rules have been amended to allow this procedure to continue.

HMRC 6 provides:

> **6.4 What should you do if you have UK Tax Allowances and use the Remittance Basis?**
> From 6 April 2008 onwards, if you have claimed the remittance basis (see Chapter 5) and your unremitted income and/or gains is £2,000 or more you will not be entitled to the allowances listed in paragraph 6.2.
> If you decide during a tax year that you are going to use the remittance basis and you are still receiving personal allowances through the PAYE system, you may not be paying enough UK tax. If you let us know, we can arrange to adjust your PAYE code so that you are not left with a tax bill relating to overpaid personal allowances at the end of the year. Otherwise we shall ask you to pay the additional tax through the Self Assessment system.
> If you want us to adjust your PAYE code you should contact the office which deals with your PAYE and ask for a tax code to be issued which does not give relief for personal allowances. This will reduce the amount of tax you may have underpaid at the end of the tax year. Your employer can't do this for you as your tax affairs are confidential between you and HMRC. Until they receive a new tax code from us, your employer will continue to deduct tax from you based on the code we originally issued before you told us you were claiming the remittance basis.

It is hard to imagine anyone wishing to do this.

(b) any reference to a payment made by the employer is to be read as a reference to a payment treated, for the purposes of PAYE regulations, as made by the relevant person.
In this subsection "the relevant person" has the same meaning as in section 689.

CHAPTER THIRTEEN

FOREIGN PENSIONS

13.1 "Foreign pension"

Section 573 ITEPA provides:

> **Foreign pensions**
> (1) This section applies to any pension[1] paid by or on behalf of a person who is outside the UK to a person who is resident in the UK.
> (2) But this section does not apply to a pension if any provision of Chapters 5 to 14 of this Part applies to it.

I refer to this as a foreign pension.

13.2 Taxation of foreign pension

Section 575 ITEPA provides:

> **Taxable pension income**
> (1) If section 573 applies, the taxable pension income for a tax year is the full amount of the pension income arising in the tax year, but subject to subsections (2) and (3). ...
> (3) That pension income is treated as relevant foreign income for the purposes of Chapters 2 and 3 of Part 8 of [ITTOIA] (relevant foreign income: remittance basis and deductions and reliefs).

This incorporates the RFI remittance rules by reference.

A UK domiciled person is allowed a 10% deduction from foreign pensions: s.575(2) ITEPA provides:

1 Section 574 ITEPA extends the meaning of pension to include voluntary pensions, to reverse the decision in *Stedeford v Beloe* 16 TC 505.

> The full amount of the pension income arising in the tax year is to be calculated on the basis that the pension is 90% of its actual amount, unless as a result of subsection (3) the pension income is charged in accordance with section 832 of ITTOIA 2005 (relevant foreign income charged on the remittance basis).

This rule was introduced when the remittance basis on foreign pensions was abolished in 1974. It is difficult to see a good reason for it but presumably this was a political douceur to ease the abolition of the remittance basis, and which has survived ever since. This deduction does not apply to a foreign domiciliary whose pension is taxed on the remittance basis. One relief was thought to suffice; fair enough. The foreign domiciliary may always choose to be taxed under an arising basis.

13.3 Lump sum from overseas pension scheme

ESC A10 provides:

> Income tax is not charged on lump sum relevant benefits receivable by an employee (or by his personal representatives or any dependant of his) from an Overseas Retirement Benefits Scheme or an Overseas Provident Fund where the employee's overseas service comprises
>
> a. not less than 75 per cent of his total service in that employment; or
> b. the whole of the last 10 years of his service in that employment, where total service exceeds 10 years; or
> c. not less than 50 per cent of his total service in that employment, including any 10 of the last 20 years, where total service exceeds 20 years.
>
> If the employee's overseas service is less than described above, relief from income tax will be given by reducing the amount of the lump sum which would otherwise be chargeable by the same proportion as the overseas service bears to the employee's total service in that employment.
>
> In addition, income tax is not charged on lump sum relevant benefits receivable by an employee (or by his personal representatives or any dependant of his) from any superannuation fund accepted as being within Section 615(6) ICTA 1988.
>
> For the purposes of this concession, the term "relevant benefits" has the meaning given in Section 612(1) ICTA 1988 and the term "overseas service" shall be construed in accordance with the definition of "foreign service" found at section 413(2) ITEPA.

The EIM provides:

15062. Overseas schemes: ESC A10 – Aim [December 2005]
The basic aim of the concession is to give exemption or relief from tax similar to that for foreign service in relation to Section 401 ITEPA 2003 (see EIM13680 and subsequent guidance).
The concession applies to lump sum relevant benefits (defined at EIM15021). This includes both lump sums received under the rules of an overseas scheme and lump sums received in commutation of pension rights under such a scheme. (The tax treatment of pension commutation payments is dealt with at EIM15150).
Note: the concession does **not** apply to benefits in the form of a pension or annuity; these remain chargeable as pension income.
See EIM15063 for the full text of the concession.
The concession is currently being reviewed in connection with the introduction of the legislation on employer-financed retirement benefits schemes with effect from 6 April 2006.

The Manual sets out the ESC and continues:

15063. Overseas schemes: ESC A10 – Text [December 2005]
Notes
- Whether a fund is within Section 615 ICTA 1988 is a matter for IBS Directorate (APSS). See EIM15064.
- For the definition of relevant benefits see EIM15021.
- For the definition of foreign service see EIM13690.
- There is an example of full exemption at EIM15425 and of partial exemption at EIM15426. ...

15064. Overseas schemes: ESC A10 – Superannuation funds [December 2005]
There can be funds that are not strictly overseas retirement benefits schemes because they are administered within the UK. However, they may have as their principal purpose the provision of benefits for employees whose service in employment is carried out wholly or mainly overseas.
The responsibility for such schemes lies with IBS Directorate (APSS), who will decide on whether or not Section 615(6) ICTA 1988 applies. If a scheme is clearly within Section 615(6) ICTA 1988 on the basis of a decision already given by IBS Directorate (APSS), and a claim for concessionary treatment under Extra-Statutory Concession A10 is received, then further reference to APSS is not required. The treatment

of any lump sum received should follow that outlined above in EIM15063 (penultimate paragraph of the concession). ...

CHAPTER FOURTEEN

TRADING INCOME

14.1 UK resident trader

Section 5 ITTOIA provides:

> **5 Charge to tax on trade profits**
> Income tax is charged on the profits of a trade, profession or vocation.

Section 5 applies to all traders,[1] but s.6 ITTOIA distinguishes between resident and non-resident traders which need to be considered separately. I first consider the rules for UK resident traders. Section 6(1) ITTOIA provides:

> Profits of a trade arising to a UK resident are chargeable to tax under this Chapter wherever the trade is carried on.

Section 7 ITTOIA provides:

> (1) Tax is charged under this Chapter on the full amount of the profits of the tax year.
> …
> (4) This section is subject to Part 8 (foreign income: special rules).

This brings in the remittance basis rules if the trading income arises from a source outside the UK. It is therefore necessary to identify the source. Section 7(5) ITTOIA states the test of source of trading income:

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1 In this chapter, reference to a "trade" includes a profession or vocation as there is no relevant distinction between them. Section 6(3) ITTOIA provides:

> "This section applies to professions and vocations as it applies to trades."

> And, for the purposes of section 830 (meaning of "relevant foreign income"), the profits of a trade, profession or vocation arise from a source outside the UK only if the trade, profession or vocation is carried on *wholly* outside the UK.

This is a statutory statement of the pre-ITTOIA case law.[2] It is a wide and strange test of source. Applying this test, if a trade is carried on partly in country A and partly in country B, the source of the income is in country A *and* country B. For the same income to have a source in two different countries is something of a paradox. The explanation is that s.7(5) ITTOIA does not provide the natural meaning of "source"; it is an artificial or deeming definition. It is fortunate (but not surprising) that countries in the British Empire which adopted a UK style income tax did not adopt this rule. Thus Commonwealth cases on the source of trading income are not relevant here.

If any part of the trade is carried on in the UK then the entire trade has a UK source and does not qualify for the remittance basis. There is no *de minimis* rule; contrast the incidental duties rule which applies to employment income.[3]

The ITH discusses the old case law, which still holds good under ITTOIA:

> **209. San Paulo case**
> [The San Paulo Railway Company (*San Paulo (Brazilian) Railway Company v Carter* 3 TC 407)] ... was a UK incorporated company with its board meetings in London. The whole of its physical undertaking was in South America and while it accepted that it was resident here it argued that its business was carried on wholly abroad where its railway was. The Courts held that the head and brain of the trading venture was here and that the profits were those of a trade partly carried on here and that, accordingly, Case I applied. ...
> **210. Trade partly in UK**
> The principle underlying the San Paulo decision is that a trade carried on partly in the UK is within Case I. The factors which decide whether a company is resident in the UK by reason of central management and control are, as will be seen, similar to those which decide whether its trade should be within Case I or Case V and the result is that for many years in the corporate sector the only

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2 See "Taxing Foreign Income from Pitt to the Tax Law Rewrite – The Decline of the Remittance Basis", John Avery Jones in *Studies in the History of Tax Law*, Hart Publishing, 2004 p.26 accessible on *www.kessler.co.uk*.

3 See 12.5 (Where are duties performed: incidental duties).

> examples seen of Case V trades were those in which a company is a partner in an overseas trade. ...
>
> **211. *Ogilvie v Kitton***
>
> But other cases were to show how difficult it was going to be, except on very exceptional facts, to establish that any trade of a resident person was carried on wholly abroad. There was, for example, Mr Ogilvie in *Ogilvie v Kitton* (5 TC 338). He lived in Aberdeen and ran a shop in Canada. To say that he ran the shop really begs the question because he simply received reports from his manager in Canada and did not in fact intervene actively in the business at all, merely taking a tacit interest in things from the information in the reports. It was held that the head and brain of the trading venture was in Aberdeen and that the profits were assessable under Case 1.

In short, if a sole trader is UK resident it is in practice impossible to arrange that his trading income has a foreign source. Section 7(4), (5) ITTOIA is a dead letter. The ITH recognises this at para 209:

> That decision [*San Paulo*] suited the Revenue very well. We no longer had to worry about remittances which after all, though very sensible for an extractive activity which had to send its produce home, did not apply well at all to the more modern industries which did not need to remit their profit and which indeed probably wanted to keep as much profit abroad as possible for the expansion of their business. And so we effectively got on to a statutory arising basis for trades which, in everyday language, were wholly overseas and we reached that position purely through the interpretation of the statute by the Courts. ...

14.1.1 *Planning for UK resident sole trader*

If a UK resident foreign domiciled individual carries on a trade partly in and partly out of the UK, the individual will be taxed in full and not under the remittance basis. In these circumstances the individual may be able to divide up his activities into two spheres – those in and those out of the UK. He will then be carrying on two separate activities, of which at least one will yield foreign source income and receive remittance basis treatment.

How is this division to be achieved? Overseas activities could be carried on by a partnership controlled abroad. The offshore partner may be a company. This was the route successfully adopted by Sir David Frost: see *Newstead v Frost* 53 TC 525. Alternatively the activities could be carried on by a company or trust. In this way foreign trading income may be converted into foreign employment or dividend income which would enjoy a more beneficial tax treatment

14.2 To whom does trading income accrue?

Since different rules apply depending on whether trading income arise to a UK or non-UK resident, it is necessary to identify the person to whom the income arises.

Suppose a non-resident trust is carrying on a trade. The trustees are taxed in accordance with the rules relating to *non*-resident traders discussed below, so the trustees would only be subject to UK income tax if the trade was carried on partly in the UK, and then only on the profits (if any) attributable to that part. However if the life tenant of a transparent (*Baker*-style) trust was resident in the UK, then the profits of the trade arise to a UK resident, and the life tenant is taxed in accordance with the rules relating to UK resident traders discussed above: he is taxed on an arising basis unless the strict condition is satisfied that the trade is carried on wholly outside the UK.

The same applies to a non-resident settlor-interested trust with a UK resident but foreign domiciled settlor. One might think that the settlor would be taxable on an arising basis only on the part (if any) of the profits attributable to carrying on the trade in the UK. The balance of the profits one might think taxable only (if at all) under the s.648 clawback. But this is not so. Since the income is deemed to be that of the UK resident settlor, the *resident* trader rules apply. Thus the settlor is subject to tax on an arising basis on all the trading income of the trust, unless the trade meets the strict condition that it is carried on *wholly* outside the UK. In practice there will often be some UK element which would be sufficient to make the entire trade taxable.

What if the trade is carried on by a non-resident company within s.720 ITA? The transferor is treated as receiving income which in the HMRC view is not trading income. However, the s.720 foreign domicile defence applies only to income which would be RFI if it were the individual's.[4] So for the purpose of the defence one must apply the UK resident trader rules.

4 See 18.13 (Section 720 foreign domicile defence).

14.3 Non-resident trader

An entirely different rule applies to *non*-resident traders. Section 6(2) ITTOIA provides:

> Profits of a trade arising to a non-UK resident are chargeable to tax under this Chapter only if they arise—
> (a) from a trade carried on wholly in the UK, or
> (b) in the case of a trade carried on partly in the UK and partly elsewhere, from the part of the trade carried on in the UK.

This raises two issues: (1) When is a trade carried on wholly or partly in the UK? and (2) If a trade is carried on partly in the UK, how does one identify the profits from that part?

This is sometimes paraphrased by asking the question whether (or to what extent) the source of the trading income is in the UK. There seems nothing wrong with that; it is the natural meaning of the word "source". But since the word "source" is used of trading income in an artificial sense in the UK resident trader rules, it is better where possible to avoid the word "source" in the context of the non-resident trader rules.

The UK case law is mostly antique because in practice double taxation treaties often apply and then the issues may not arise. But of course that is not always the case. The ITH is helpful and erudite.[5] There are two other sources of guidance: cases on unilateral tax credit and non UK tax cases. I should comment briefly on these.

14.3.1 *Unilateral tax credit and place where trading income arises*

Section 790(4) ICTA provides:

> Credit for tax paid under the law of the territory outside the UK and computed by reference to income arising or any chargeable gain accruing in that territory shall be allowed against any UK income tax or corporation tax computed by reference to that income or gain ....[6]

I refer to this as "**Unilateral tax credit**". It depends on where income

5 Tax Bulletin 18 provides a brief summary, not set out here.
6 See 41.3 (Unilateral tax credit).

arises. The issue arose in *Yates v GCA International*[7] where *Smidth* principles (ie non-resident trader rules) were applied. The ITH para 827 provides:

> The *Gaffney Cline* case [*Yates v GCA International Ltd* 64 TC 37], which is described in Chapter 6 (ITH628) was concerned with a not dissimilar problem in reverse. The point there was what part, if any, of the income from services arose in Venezuela when the contract was made in Venezuela but the services were performed partly in Venezuela but mainly in the UK. That is not necessarily the same as asking whether the trade was exercised in only one or in both of the countries – that was made clear in the judgement. But the judge looked for guidance to the criterion of Atkin LJ in the *Smidth* case 'where do the operations take place from which the profits in substance arise' when deciding that the income arose partly in Venezuela and partly in the UK.

14.3.2 *Non-UK tax cases and place where trading income arises*

There are many Commonwealth cases, including some modern cases, which ought to be helpful. However, the Commonwealth legislation is differently worded. It is necessary to consider the fundamental question whether the test is the same, i.e. whether the Commonwealth cases have any relevance in the UK (and vice versa). This question has received contradictory answers.

The Southern Rhodesia statute imposes a charge on the amount:

> received by ... any person ... *from any source within the Territory* ...

In *Rhodesia Metals v CT*, the Privy Council said of this provision:

> ... numerous cases founded on the various Income Tax Acts, English, Australian, New Zealand and South African, were cited chiefly as to business in buying and selling commodities, such as *Lovell and Christmas v CT*[8] (New Zealand); *Maclaine v Eccott*[9] (England); *Studebaker Corporation of Australasia v CT*[10] (Australia); and two South African cases, *CT v William Dunn & Co*;[11] and *Overseas Trust*

7 64 TC 37.
8 [1908] AC 46.
9 [1926] AC 424.
10 (1921) 29 CLR 225.
11 (1918) SALR (AD) 607.

> *Corporation v CIR*.[12]
> Their Lordships have no criticisms to make of any of those decisions, but they desire to point out that
> [1] decisions on the words of one statute are seldom of value in deciding on different words in another statute, and that
> [2] different business operations may give rise to different taxing results.

Point [2] is obviously correct but we are here concerned with point [1]. The Privy Council continue:

> [3] If the charging words of the English statute[13] are looked at,
> "(i.) annual profits or gains arising to any person, (ii.) residing in the UK from any trade wherever carried on, and (iii.) whether resident in the UK from any trade exercised within the UK";
> they are obviously different from the Southern Rhodesian charging words,
> total amount [other than capital] received by .... any person .... from any source within the Territory.
> [4] It is desirable, also, to point out that, at any rate for different taxing systems, income can quite plainly be derived from more than one source even where the source is business. For instance, in the case of the business of a railway company whose railway is situate abroad, as in *San Paulo (Brazilian) Railway Co. v Carter*,[14] while the English company may be assessed in England on the whole of its profits because it carries on part of its business there, yet it could not be doubted that so much of the profits of the business as were in fact earned from running the railway in Brazil were derived from exercising a business in Brazil; and still less could it be doubted that the sums received by the company in Brazil were received from a source in Brazil.[15]

Lord Atkin correctly states at [4] that the Commonwealth legalisation and case law has no relevance to the test of source for UK resident traders.[16]

12 (1926) SALR (AD) 444.

13 The reference is to what became s.18 ICTA, now recast in a different form in ITTOIA.

14 3 TC 407.

15 [1940] AC 774 at p.788–9.

16 See 13.1 (UK resident trader rules).

It is suggested that the Commonwealth legislation does apply the same test as s.6(2) ITTOIA (non-resident traders). For this purpose the Commonwealth cases *are* persuasive authorities in the UK. For the object of the non-resident trader rules is to avoid double taxation and ensure that income is taxed in one and only one jurisdiction. That object can only be achieved if there is an international "common law" on the subject. In practice this is the view taken. For instance, the ITH refers to *Kirk*.

The same applies to Hong Kong, where the charge is on profits "arising in or derived from Hong Kong". *Smidth* is the basis of the Hong Kong case law.[17] In an Indian statute, the charge was on profits "accruing or arising in British India". This was held to be substantially the same as in Hong Kong.[18]

Unfortunately the Commonwealth cases are remarkably inconsistent.[19]

14.4 Place where contract made

The ITH provides:

> **813. *Erichsen v Last***
> Another very early case was *Erichsen v Last* [4 TC 422] which was heard in the Court of Appeal in 1881. It is a highly important case and, curiously, was not published in Tax Cases until some twenty years after the decision. It is perhaps a pity that *Erichsen v Last* was concerned with a very special sort of trade – the relaying of telegraph messages. The application of the ideas which emerge from *Erichsen v Last* to other trades is, because of its special facts, rather difficult.
> The facts are simple enough. Erichsen was the UK representative of the Great Northern Telegraph Company of Copenhagen. The company was not resident here but it had three cables running across the North Sea to bases in Scotland and it had a staff of operators here. Messages were collected through an arrangement with the Postmaster General. The Post Office collected the money and deducted its agreed remuneration before handing over the messages to the company's operators here. The company's own staff then transmitted the messages across the North Sea. Thereafter, depending on their destination, they passed through cables owned by the Danish and Russian governments to their destinations which might have been as far off as Japan. The company made a weak sort of claim that

17 *IRC v HK-TVB* [1992] STC 723 at p.728.

18 *IRC v Hang Seng Bank* [1990] STC at p.739 though "it may be that there is some marginal difference in the shades of meaning conveyed by the two phrases".

19 See Michael Littlewood's scholarly article "The Privy Council, the Source of Income and *Stare Decisis*" [2004] BTR 121 and "The Territorial Source of Income" Robert Venables QC, OTPR, Vol 7, p.177.

it was not trading here but it went on to say that if it was, it ought to be taxed only on the profit arising from the relaying of the messages along the main cable to Denmark. It was making the point that some of the profit arose from the transmission along other cables which had absolutely nothing to do with the UK. The first thing the judgments in the Court of Appeal make clear is that the matter is wholly one of fact. The judgments then separate two questions for decision. First, is there trading in the UK? Brett LJ says this on page 425. His words are important because it is here that the significance of contract – place of contract – begins.

> "Now, I think it would be first of all nearly impossible and second wholly unwise to attempt to give an exhaustive definition of when a trade can be said to be exercised in this country. The only thing that we have to decide is whether upon the facts of this case it can be said that this company is carrying on a profit earning trade in this country. Now I should say that wherever profitable contracts are habitually made in England by or for a foreigner with persons in England, because those persons are in England, to do something for or supply something to those persons, such foreigners are exercising a profitable trade in England, although everything done by or supplied by them in order to fulfil their part of the contract is done abroad. The profit arises to them from the contract which they make. The profit which they derive can only be derived from the payment which is to be made to them by the person with whom they contract. In the given case they would not have any such contract as they are in the habit of making unless it was a contract made in England with a person who is in England because he is in England. Observe, if the person or someone acting for him were not in England he would not be wanting to send a telegraph message from England".

The language is now over 100 years old and while it may perhaps look a little old fashioned today its meaning seems plain. The Court was saying: "You, the customer, are in England and because you are here you want goods here (or in the case in point, you want a message sent from here). The profit comes from the contract, the contract is here and there is trading in England and it is nonetheless trading in England even though the goods come from abroad or the service is provided through electric cables which are partly abroad". ...

815. First champagne cases

Erichsen v Last was followed by the so-called champagne cases. There were three leading champagne cases. In the first two, the Revenue succeeded in a claim that the French champagne houses concerned were trading in the UK through agents in London. In the Pommery case [*Pommery and Greno v Apthorpe* 2 TC 182] there was no express finding as to where contracts were made but most orders were met from stock held in the UK. In the Werle case [*Werle v Colquhoun* 2 TC 402] the Court of Appeal made it clear that they considered the contracts to be made by the agents here on behalf of their principal.

These two houses were producers of champagne as well as sellers of champagne and it is reasonably clear that the Revenue did not claim to tax the producer's profit. In the Pommery case at page 189, the Judge specifically referred to the difficulty of calculating the profit; he said that there might be some difficulty as to the manner of calculation in deciding what amount of expenditure to put against the profits and wondered whether it would be proper to look at the goods sent over to England and to put a fair valuation upon them as they arrived. That he said was a matter of quantum, a matter for the consideration of persons skilled in such things.

In the Werle case on page 413 Fry LJ had a similar approach, he said

> "A small shopkeeper... is plainly carrying on a trade in the place where the shop is ... The question, however, becomes more difficult when the trade is carried on, as in the present case, in a far more complicated manner ... when the contract may be in one place, the goods in another, the principal in another and the goods may be delivered in some other place. We have, however, simply to do this, to take all the relevant facts and the mode in which the business is carried on, and to ask ourselves whether that business be or be not carried on within the UK. It appears to me that the same business may in some sense be carried on in many places. The Head Office of a firm, the place where the goods are manufactured, the place where the contracts are made, may all of them be places in which the business or parts of the business is or are carried on. Now, in the present case what we find is this, that the appellants reside in France, carrying on there the business of vineyard proprietors, champagne makers and champagne merchants, no doubt a large portion of that business is carried on within France, but a portion of that business is that of champagne merchants. Now, that means, as I understand, the selling of champagne and that business they carry into effect in England through the intervention of a firm of agents in this country."

816. Contracts abroad

The last of the champagne cases is *Grainger v Gough* [3 TC 311 and 462] and it is a very significant case. The Court of Appeal made no distinction between this and the earlier cases and found that the champagne house was liable on its trading here. ...

But Lord Esher and his fellow judges were overruled by the House of Lords on the question of whether there was liability at all. That was on the basis that in this particular case, contracts were not made in the UK. Although to the customer there may have been little difference between buying through the agents in the first two cases and buying through the agents in the third, there was a difference in the arrangements which the House of Lords saw as vital in determining the non-resident's liability to UK tax. In finding that the contracts were not made in the UK the House of Lords drew the now classic distinction between trading in the UK which involves liability and trading with the UK which does not. Non-residents with customers here commonly rely on this distinction.

The House of Lords may well have had it in mind that if we sought too strenuously to tax foreigners who sold goods here, we might be faced with hostility by countries to which we were exporters and which might seek to tax those exporters in parallel circumstances. The thought is not directly expressed but there is a hint of it at the end of Lord Herschell's judgment on page 468.

14.5 Rejection of place of contract test

The ITH provides:

> **817. Place of contract not decisive**
> There are later judgments and very important judgments which tend to water down a little the great emphasis on place of contract. Lord Atkin speaking in the Smidth case [*Smidth & Co v Greenwood* 8 TC 193] in 1921 said this
>
> > "It (the place of contract) is obviously a very important element in the enquiry and if it is the only element the assessments are clearly bad. The contracts in this case were made abroad. But I am not prepared to hold that this test is decisive. I can imagine cases where a contract of resale is made abroad, and yet the manufacture of the goods, some negotiation of the terms, and complete execution of the contract take place here under such circumstances that the trade was in truth exercised here. I think that the question is, where do the operations take place from which the profits in substance arise?"'
> >
> > (Emphasis added)

This is sometimes called "the operations test". It is not in fact a "test" as such, because further guidance is needed to identify where the profits in substance arise. It is however a rejection of the "place of contract test". The ITH gives one further quote to drive the point home:

> In one of the few fairly modern[20] cases on this subject, the Firestone case [*Firestone Tyre & Rubber Ltd v Lewellin* 37 TC 111 at page 142] in 1957, Lord Radcliffe said this
>
> > "But he (Counsel for the Appellants) rightly reminded us that more than once the place where the contract is made has been spoken of as the 'crucial' test or, again, as the 'most vital' element. Speaking for myself, I do not find great assistance in the use of a descriptive adjective such as 'crucial' in this connection. It cannot be intended to mean that the place of contract is itself conclusive. That would be to re-write the words of the Taxing Act, and could only be justified if there was nothing more in trading than the act of sale itself. There is of course much more. But if 'crucial' does not mean as much as

20 I guess that this passage in the ITH was written in the 1980s.

> this, it cannot mean more than that the law requires that great importance should be attached to the circumstance of the place of sale. It follows, then, that the place of sale will not be the determining factor if there are other circumstances present that outweigh its importance or unless there are no other circumstances that can."'

This approach is adopted in the Privy Council:

> The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profits in question.[21]

14.6 Where profits in substance arise

So we turn to the question of where profits in substance arise. The short answer is that there is no short answer. The ITH provides:

> **820. NRs: profits in substance**
> It is consistent with the words of Brett LJ at the start of the quotation in ITH813 to say that no neat formula to decide what is, and what is not, trading in the UK can be devised. ...

Circumstances vary so widely that it is not possible to devise a single test that fits all cases.[22] It is not, of course, an answer to say that the question is just a question of fact. The comments made at 11.11.10 (Unsatisfactory approaches to identifying source of interest) apply here too.

14.7 Mere buying

The ITH provides:

> **812. Purchasing is not trading in**
> The mere buying of goods here does not amount to trading here. That was decided in the very first case in these matters, *Sulley v AG* [2 TC 149], in 1860. A New York firm purchased goods in England for sale in America. It had an office here where the English resident partner saw to the purchasing and shipping of the goods. The Court of Exchequer (a

21 *IRC v. Hang Seng Bank* [1990] STC 733.
22 "No simple legal test can be employed"; see *IRC v Orion Carribean.*

> Court of Appeal) found that "The profits of the firm in America do not accrue in respect of any trade carried on in this country, but in respect of the trade carried on in New York, where the main business is conducted".

Mere buying is also included in the list of auxiliary activities which do not amount to trading in the UK.[23]

14.8 Buying and selling

The ITH para 820 continues:

> But we do attach much importance to Lord Atkin's approach to the question of "trading in" in the *Smidth v Greenwood* case quoted in ITH817 above – "where do the operations take place from which the profits in substance arise".
>
> We have come to adopt this test as the principal criterion for determining whether there is "trading in". But it should be borne in mind that the Smidth company was found not to be trading in the UK. Although it had an agent in the UK to advise prospective purchasers and assist with the installation of machinery, the profits in substance arose from the sale of that machinery under contracts made abroad. ...
>
> **821. Merchanting: Place of sale**
>
> The decision in the *Smidth* case supports the conclusion that in the case of merchanting business (buying and selling goods for profit), the trade is normally exercised at the place where the contracts for sale are made – that is where the operations take place from which the profits in substance arise.
>
> It may help, in considering why that should be the relevant place, to put the decided cases aside and to ask what sort of facts could possibly be significant in leading to an answer to the question of whether there is trading in the UK. Where merchanting is concerned – buying and selling – there will often be a central office where questions of policy are considered and finance is arranged. There is the buying of the goods and perhaps the holding of a stock of goods. Then there is the search for customers and there is the actual contract for sale. That contract may be at a price laid down in a distant Head Office or it may be for a price negotiated with some skill on the spot. Finally there is delivery involving the question where does the lawful property in the goods pass from seller to buyer.
>
> Few if any of the elements described above necessarily call for a presence in this country and the functions involved can be located where the trader wishes. Most countries take the same view as we do about buying. The Court in *Sulley's* case simply said "It would be most impolitic thus to tax those who come here as customers." The place of sale, as identified by the place of contract for sale, is

23 See 14.15 (Trading in UK: preparatory and auxiliary activities).

a reasonable means of determining the location of trading; trading profit becomes measurable only when there is a sale and without a sale there can be no profit.

822. Place of sale unreliable

But the place of sale, like other elements, can be moved. Even where the trade is that of buying and selling some qualification is needed to the assertion that there is trading in the UK if the contracts for sale are made here. It is generally taken for granted that it must be so if the sales are to people who are here. But, as is apparent from ITH830–ITH834 below which look at the place of contract, just when and where a contract is concluded can depend on fine distinctions and may even be a matter of chance. If, for example, a non-resident advertises goods for sale in a newspaper here and the customer responds by a telephone call to the non-resident during which agreement is reached or there is an exchange of telexes, the contract may technically be made in the UK even though the non-resident does very little here at all. We do not know what view the Courts would take of that though they have certainly not ruled out the possibility that while there may be contracts here there may nevertheless be no trading here [See *Belfour v Mace* 13 TC 558].

There may be similar doubt when sales are to people who are not resident here. The problem can be illustrated by a simple example. A New York art dealer has a picture which a Frenchman is interested in. The American and the Frenchman happen to meet in London which both are visiting for a few days holiday. In their hotel they agree on a price for the picture and conclude the deal. The contract is made here. Is the American trading in the UK? The matter is considered further on in chapter 9 (ITH947).

One may devise improbable examples of this kind without doing more than to highlight the difficulties which absolute reliance on the place of contract as a test would involve. Other cases of difficulty are those where there is reason to believe that, although contracts are formally made abroad, everything is really done here short of signing a piece of paper. In such cases we would say that there is trading here. The problem in such a case is largely one of proof. See, for example, the comments in chapters 9 (ITH914) and 10 (ITH1017).

The Hong Kong Revenue have issued useful guidance notes. It is suggested that their status in an English court should be the same as that of a respected textbook:

TRADING PROFITS

6. The question of the locality of profits derived from trading in commodities or goods has produced the most controversy. This issue is important and needs to be clarified. Generally the determining factor, as indicated in the Privy Council decisions, is the place where the contracts for purchase and sale are effected. However, as the Court of Appeal noted in *Magna,* the totality of facts must be looked at in determining what the taxpayer did to earn the profit: *"... the question where the goods were bought and sold is important. But there are other questions: For example: How were the goods procured and stored? How were the sales solicited? How were the orders processed? How were the goods*

shipped? How was the financing arranged? How was payment effected?". This reflected the statement by the High Court that *"More often than not, it would not be the quantity of activities but the nature and quality of them that matters more. The cause and effect of such activities on the profits is the determining factor. It is what role such activities played and the relative importance of them in the making of profits that would usually tilt the scale and not the number of activities carried out at a particular place."* The headnote to Case No. *D9/89*, quoted by the Court of Appeal in *Magna,* is also worthy of note: "*Generally, the employment of staff and the maintenance of an office in Hong Kong, with all necessary services and facilities including telephone and telex, are the essence of a trading company's activities. Where these are all in Hong Kong, it could be concluded that the resultant profits have a Hong Kong source. The fact that goods are located and delivered outside Hong Kong is not material for this purpose."*

7. The Department considers that because the locality of profits is a hard, practical matter of fact, "effected" cannot merely mean legally executed (as this would depend on formal legal rules of offer and acceptance) and thus must contemplate the actual steps leading to the existence of the contracts including the negotiation and, in substance, conclusion and execution of the contracts.

8. On the basis of the opinions expressed in paras 6 and 7 and in the light of the various court decisions, the Department's views which are reflected in its assessing practice on the locality of profits derived from trading in commodities or goods by a business carried on in Hong Kong can be summarised as follows -

(a) Where both the contract of purchase and contract of sale are effected in Hong Kong, the profits are fully taxable.
(b) Where both the contract of purchase and contract of sale are effected outside Hong Kong, no part of the profits are taxable.
(c) Where either the contract of purchase or contract of sale is effected in Hong Kong, the initial presumption will be that the profits are fully taxable. Matters, such as those mentioned in para 6 above, will be examined to determine the issue.
(d) Where the sale is made to a Hong Kong customer, the sale contract will usually be taken as having been effected in Hong Kong.
(e) Where the commodities or goods are purchased from either a Hong Kong supplier or manufacturer, the purchase contract will usually be taken as having been effected in Hong Kong.
(f) Where the effecting of the purchase and sale contracts does not require travel outside Hong Kong but is carried out in Hong Kong by telephone, fax etc., the contracts will be considered as having been effected in Hong Kong.
(g) The purchase and sale contracts are important factors but the totality of facts must be looked at to determine the locality of the profits.

9. There may be cases where the activities of a Hong Kong trading business are limited to the following -

(a) issuing or accepting an invoice (not order) to or from an ex-Hong Kong customer or supplier (whether related or not) on the basis of contracts of sale or purchase already effected by an ex-Hong Kong associate;
(b) arranging letters of credit;

(c) operating a bank account, making and receiving payments; and
(d) maintaining accounting records.

This situation commonly arises when a Hong Kong business, as a member of a group and pursuant to group directives, carries out the above activities and "books" the profits in Hong Kong. Provided the activities of the Hong Kong business do not include the acceptance or issue of sale or purchase orders in or from Hong Kong, the profits would not be taxable. In other words, the Department considers that where the Hong Kong business accepts or issues sale or purchase orders in Hong Kong, the guidelines in para 8 apply.[24]

14.8.1 *Situs of assets sold*

In *IRC v HK-TVB* the Privy Council said:

> profits accruing to a resident taxpayer from the sale of foreign immovable property are likely to arise in the country where that property is situated although both the contracts of purchase and sale thereof are made in the country of residence of the taxpayer: *Liquidator, Rhodesia Metals Ltd. v. Commissioner of Taxes* [1940] AC 774.[25]

The Hong Kong Revenue adopt this approach:

> 20. The Department regards the locality of the following types of profits to be as follows–
> ...
> (b) Profits from the sale of real estate. *Locality*: location of the property.
> (c) Profits from the purchase and sale of listed shares. *Locality*: location of the stock exchange where the shares in question are traded.
> (d) Profits from the sale of securities issued outside Hong Kong and not listed on an exchange. *Locality*: place where the contracts of purchase and sale are effected (except financial institutions in instances where section 15(1)(*l*) applies).[26]

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24 Departmental Interpretation & Prospective Notes No. 21, Locality & Profits, March 1998 *www.ird.gov.hk/eng/pdf/e_dipn21.pdf*.

25 [1992] STC 723 at p.729.

26 Departmental Interpretation & Prospective Notes No. 21, Locality & Profits, March 1998 *www.ird.gov.hk/eng/pdf/e_dipn21.pdf*.

14.8.2 *Buying and selling through an agent*

SP 1/01 provides:

> 22. If a non-resident carries on a financial trade outside the UK, any transactions carried out through a UK investment manager are likely to amount to trading in the UK. That is so whether there is a discretionary agreement or whether the manager acts on the instructions of the non-resident.

14.9 Services

The ITH continues:

> **826. Where work is done**
> Many trades are not limited to merchanting. Where services are concerned, we tend to give greater weight to the place where the service is provided.[27]

The Hong Kong Revenue adopt this approach:

> 20. The Department regards the locality of the following types of profits to be as follows -
> (e) Service fee income. *Locality*: place where the services are performed which give rise to the fees.[28]

This is consistent with the statutory rule for unilateral tax credit in s.790(4) ICTA:

> Credit for tax paid under the law of the territory outside the UK and computed by reference to income arising or any chargeable gain accruing in that territory shall be allowed against any UK income tax or

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27 The ITH para 826 continues:
> There are particular difficulties with transmission services with which the approach is to say that the service is given where the act of transmission begins, following the case of *Erichsen v Last* already quoted in ITH813.

28 The ITH para 826 continues:
> There are particular difficulties with transmission services with which the approach is to say that the service is given where the act of transmission begins, following the case of *Erichsen v Last* already quoted in ITH813.

> corporation tax computed by reference to that income or gain (*profits from, or remuneration for, personal or professional services performed in that territory being deemed for this purpose to be income arising in that territory*).[29]

This raises the question of where the services are provided or performed.[30] Sometimes the answer is obvious. In *Brackett v Chater*[31] a surveyor contracted himself to a Jersey company (owned by a Jersey trust that Brackett had made although this was not material). He became its employee. Clients contracted with the Jersey company but Mr Brackett did all the work in the UK using facilities available to him at the offices of the firm in which he was previously a partner. The Jersey company was held to be trading in the UK.

Likewise the Hong Kong Revenue say:

> It should be noted that in the case of an investment adviser that where the adviser's organisation and operations are located only in Hong Kong, profits derived in respect of the management of the clients' funds are considered to have a Hong Kong source. Included in chargeable sums are not only management fees and performance fees but also rebates, commissions and discounts received by the adviser from brokers located in Hong Kong or elsewhere in respect of securities transactions executed on behalf of clients.[32]

14.9.1 *Commissions*

The Hong Kong Revenue guidance provides:

> **SALE OR PURCHASE COMMISSION**
> 23. This refers to situations where commission income is earned both by securing buyers for a manufacturer's products and by securing manufacturers to make products required by customers. Typically the commission income is a percentage of the invoiced value of the goods. In such cases the Department considers that the activity which gives rise to the commission income is the

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29 See 14.3.1 (Unilateral tax credit and place where trading income arises).

30 I do not think there is a difference between "provided" and "performed" in this context.

31 60 TC 134 & 639.

32 Departmental Interpretation & Prospective Notes No. 21, Locality & Profits, March 1998 *www.ird.gov.hk/eng/pdf/e_dipn21.pdf.*

arrangement of the business to be transacted between principals. The source of the income is the place where the activities of the commission agent are performed. The place where the principals are located, how they are identified by the commission agent and the place where incidental activities are performed prior to or subsequent to the earning of the commission are not generally relevant.

24. Commission income may also arise where a business is carried on in Hong Kong but the activities which give rise to the commission are not in Hong Kong. In such cases, the commission is not taxable. Typical of these situations are the following examples -

Example 3 - Sales or purchase agencies

A Hong Kong business holds the "Far East Area" sales or purchasing representation for a product or group of products sold into the area or sourced in the area by principals who are associated concerns, the Hong Kong business and the associates being members of a group under the control of a common parent organisation. The Hong Kong business is appointed agent for the area, either by formally executed agreements or by a directive from the parent organisation and is remunerated by a "commission" on all sales and/or purchases in its area. The Hong Kong business may either -

(a) actively solicit orders ex-Hong Kong, on behalf of its principals by sending employee representatives overseas for the purpose or by employing sub-agents overseas; or

(b) factually do nothing whatsoever, either itself or through subagents.

Example 4 - Passive commission

A similar organisational set-up to the agencies above, but in this case the Hong Kong business is given sales or purchase responsibility for group products in the "Far East Area" as a principal. Factually, the Hong Kong business is unable to handle all or any of the group range of products and sales into or purchases from the area are therefore entirely made by associated concerns. It is never intended that the Hong Kong business will perform any purchasing or sales function. The Hong Kong business receives an "infringement commission" for which it does nothing (except possibly the rendering of some "sales service" ex-Hong Kong).

Alternatively, it may be the case that the Hong Kong business sells or buys group products in Hong Kong (profits thereon are, of course, subject to Hong Kong profits tax) and in addition receives "commissions" on sales or purchases by associated concerns in the "Far East Area". These commissions are paid in pursuance of a parent organisation directive. The Hong Kong business has no formal function or contractual position in relation to the associates' transactions in the "Far East Area", i.e. it has no "area responsibility" either as principal, agent or sales representative and renders no service in respect of the commission it receives.[33]

33 Departmental Interpretation & Prospective Notes No. 21, Locality & Profits, March 1998 *www.ird.gov.hk/eng/pdf/e_dipn21.pdf.*

14.9.2 *Services performed in different places*

In *Yates v GCA International*[34] a UK resident company provided services (an investigation into oil fields in Venezuela). Some of the work was done in Venezuela and some in the UK. The company (being UK resident) was in principle taxable on all trading income, but subject to unilateral tax credit relief for Venezuela tax on income arising in Venezuela. The *Smidth* principles were applied and so (unsurprisingly) part of the profits were held to arise in Venezuela.[35]

Lastly the ITH comments on *Hang Seng Bank*:

> The judge also referred to a Privy Council case, the Hang Seng Bank [*IRC v Hang Seng Bank* [1990] STC 733], where the point at issue was also where income arose but under Hong Kong law. The income arising from financial transactions outside Hong Kong was held to arise where the transactions took place. But, as with Gaffney Cline, the case has to be treated with caution in the context of "trading in" being both on a different point and governed by foreign law.

14.10 Construction and engineering works

The ITH para 826 continues:

> Where construction and engineering works are concerned we say that the construction works are the essential operations and it is normally immaterial where the contract is signed – there is support for this in the Muller case [*WH Muller & Co (London) Ltd v Lethem* 13 TC 151].

14.11 Manufacturing and selling

The ITH para 826 continues:

> There may be more than one part of the trade which can be identified as the profit producing part. There can be the case where there is manufacture abroad and selling here or manufacture here, and selling abroad. To look at the first situation, manufacture abroad and selling here, it is reasonably clear from the champagne cases that the Revenue only claimed to tax the selling profit and there is nothing in the

34 64 TC 37.

35 See 14.3.1 (Unilateral tax credit and place where trading income arises).

> judgments to suggest that it was entitled to more. The question is considered more fully in chapter 9 (ITH920). As to the second situation, manufacture on its own is certainly trading, even though there may be no sales here, and the old judgments tend to support the view that we should in such circumstances seek, on some sensible basis, to tax only the manufacturing profit. There was a Privy Council [*Commissioners of Taxation v Kirk* [1900] AC 588] case in the early part of the century, an Australian case, which supports that idea and it is what we have in fact always done.

See too *IRC v Hang Seng Bank*:

> If he has … engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where ... the profit making activity carried on. There may, of course, be cases where the gross profits deriving from an individual transaction will have arisen in or derived from different places. Thus, for example, goods sold outside Hong Kong may have been subject to manufacturing and finishing processes which took place partly in Hong Kong and partly overseas. In such a case the absence of a specific provision for apportionment in the Ordinance would not obviate the necessity to apportion the gross profit on sale as having arisen partly in Hong Kong and partly outside Hong Kong.[36]

The Hong Kong Revenue guidance provides:

> **MANUFACTURING PROFITS**
> 13. The Department considers that, where goods are manufactured in Hong Kong, the profits arising from the sale of such goods will be fully taxable because the profit making activity is considered to be the manufacturing operation carried out in Hong Kong.
> 14. In the situation where a Hong Kong company manufactures goods partly in Hong Kong and partly outside Hong Kong, say in the Mainland, then that part of the profits which relates to the manufacture of the goods in the Mainland will not be regarded as arising in Hong Kong.
> 15. A Hong Kong manufacturing business, which does not have a licence to carry on a business in the Mainland, may enter into a processing or assembly arrangement with a Mainland entity. Under these arrangements, the Mainland entity is responsible for processing, manufacturing or assembling the goods that

36 [1990] STC 733 at p.740. The *dictum* to the contrary in *IRC v HK-TVB* [1992] STC 723 at p.730h can be disregarded.

are required to be exported to places outside the Mainland. The Mainland entity provides the factory premises, the land and labour. For this, it charges a processing fee and exports the completed goods to the Hong Kong manufacturing business. The Hong Kong manufacturing business normally provides the raw materials. It may also provide technical know-how, management, production skills, design, skilled labour, training and supervision for the locally recruited labour and the manufacturing plant and machinery. The design and technical know-how development are usually carried out in Hong Kong.

16. In law, the Mainland processing unit is a sub-contractor separate and distinct from the Hong Kong manufacturing business and the question of apportionment strictly does not arise. However, recognising that the Hong Kong manufacturing business is involved in the manufacturing activities in the Mainland (in particular in the supply of raw materials, training and supervision of the local labour) the Department is prepared to concede, in cases of this nature, that the profits on the sale of the goods in question can be apportioned. In line with paras 21-22 below, this apportionment will generally be on a 50:50 basis.

17. If, however, the manufacturing in the Mainland has been contracted to a sub-contractor (whether a related party or not) and paid for on an arm's length basis, with minimal involvement of the Hong Kong business, the question of apportionment will not arise. For the Hong Kong business, this will not be a case of manufacturing profits but rather a case of trading profits. Profits of the Hong Kong business will be calculated by deducting from its sales the cost of goods sold, including any sub-contracting charges paid to the sub-contractor in the Mainland. The taxation of such trading profits will be determined on the same basis as for a commodities or goods trading business.

18. The following examples further illustrate the Department's views on this subject -

Example 1

A Hong Kong company manufactures goods in Hong Kong and sells them to overseas customers. The fact that the company has sales staff based overseas does not give a part of the profits an overseas source. This is not a case for apportionment. The whole of the profits are liable to profits tax.

Example 2

A Hong Kong garment manufacturer has a factory in the Mainland where sweater panels are knitted. These panels are then transported to the manufacturer's factory in Hong Kong where they are sewn together into finished garments for sale. This would be a case where the manufacturing profit could be apportioned.

19. As a corollary to example 1, where a company manufactures goods outside Hong Kong and sells them to Hong Kong customers, the manufacturing profits are not liable to profits tax. However, in the exceptional case where the sale activities in Hong Kong are so substantial as to constitute a retailing business, the profits attributable to the retailing activities are fully taxable.[37]

37 *www.ird.gov.hk/eng/pdf/e_dipn21.pdf.*

14.12 Use of UK commodity markets

The ITH provides:

929. Is use of the markets "trading in"?
It is a good thing for this country that these markets exist. There are all sorts of spin-off advantages. Big business has to be financed and insured and there are shipping services and all sorts of peripheral activities which are good both for the people who are involved in them and for the country's balance of payments. Looking at the physical markets the produce concerned may or may not come to this country. A Brazilian plantation owner may sell his cocoa in London although the buyer may be in France. A broker here will sell to another broker acting on behalf of the buyer and the contract will be made here. So the question arises – is the Brazilian producer trading in London and until the end of the last century it never occurred to anybody that this might be so.
Then came clarification by the Courts on the meaning of trading in the UK and the possibility that the fact of a contract being made by an agent in London could involve the principal in UK tax. It appeared open to the Revenue to contend that the principal was carrying on the selling part of his trade in London or even carrying on the whole trade in London. The Revenue had contended neither of those things; to have done so would have frightened off the foreign users of our markets. In any event, in those early days, the non-resident principal could have arranged that his London brokers did not receive the profits or gains.
But in 1915 everything changed because it was then provided that the receipt of the profits or gains would no longer count and the business world was worried. The Revenue said that it had always regarded business done on our markets through brokers as trading with the UK rather than trading in the UK. But the business world was not satisfied. The difficulty was clear enough. If, as some of the early cases might suggest, the bare making of a contract here is such a vital matter, there is a risk that anybody using our markets might be held to be trading here. The Revenue's former view that in normal circumstances that constituted trading with rather than in the UK is not easily defensible.
930. Pt VIII TMA 1970: Trading in: Can there be any profit?
But accepting that a primary producer, a Brazilian plantation owner selling cocoa in London, is trading in the UK, where is the profit? Such commodities have a world market price at any time; it is an essential function of the market to decide exactly what that price is. If it is decided that the Brazilian producer is trading in the UK he must be charged either as a seller of cocoa or as a cocoa grower. If he is not charged as a grower and, to put it no higher it would be stretching things rather to do so, it is hard to see how any profit can be said to arise in London as a seller of cocoa. The position is entirely different from that of the French champagne grower of the type referred to in ITH815 of chapter 8, who may at least be regarded as making a merchanting profit here. In that situation one would look at the market value of the champagne in bulk and then at the price (wholesale or retail) actually realised in this country. But where commodities like

> bulk tin or rubber or cocoa are concerned, the position is otherwise. These things are traded in our markets precisely to determine what their market value is and to dispose of them at that price.
>
> **931. Dealer**
>
> In some cases the primary producer may not sell directly in London but sell to an intermediary in the producing country who in turn sells on the London market. The trade here is then clearly that of selling and if the intermediary does not purchase at world prices – there may, for example, be a reserve price – it may be possible to identify a profit or a loss. But if the intermediary sells through a broker within the exemption described in the following paragraphs then the exemption runs just the same. But it sometimes happens that, although the contracts are made through a broker, the seller has a presence here – a branch or an agent – which plays some part in the selling process. It may, for example, instruct the brokers. The question then is whether what is done is sufficient to enable us to say that the non-resident is trading also through that branch or agent. The terminal markets may be used by a non-resident dealer in commodities simply to hedge purchases or sales of raw materials which take place outside the UK. The hedging transactions may amount to trading here but, again, the broker exemption may apply unless the non-resident has a presence here, other than the broker, which is involved with the hedging transactions. If the exemption does not apply, there is then the question of the extent, if any, to which the results of the related transactions outside the UK should be taken into account in measuring the taxable profits. This is an area of difficulty and International Division should be consulted in such a case.

In practice the point is not important because the broker exemption applies.[38]

14.13 Leasing and licensing tangible property

The position for property income from land is governed by statute and case law is irrelevant for UK tax.[39]

What about leasing[40] chattels (e.g. pictures)? It is helpful to consider trading and non-trading cases separately.

14.13.1 *Leasing chattels without trading*

If there is a simple lease (without a trade) the source of the income is the

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38 See 33.1 (Investment Manager exemption).

39 See 15.1 (Property income).

40 References to leasing in this paragraph include licensing: there is no material distinction for our purposes.

chattel (not the contract) and one would expect the source to be where the chattel is situate.

In *IRC v Hang Seng Bank*, the Privy Council said:

> If the profit was earned by the exploitation of property assets as by letting property ... the profit will have arisen in or derived from the place where the property was let ...[41]

But this was "explained" in *IRC v HK-TVB*:

> When Lord Bridge used the words "place where the property was let" he must have been referring to the place where the property was situated and not to the place or places where the lease happened to have been signed.[42]

Although the comment was made in the context of immoveable property, it is considered that the same applies to chattels.

It is true that the chattel may be moved, but most chattels do not move often. If a picture was moved permanently, it is unclear whether the source changes. It is tentatively suggested that the source changes.

If the chattel were a mobile asset (a plane or yacht) then it is suggested that one should not adopt the rule that the source is where the asset is situated. It is rational to have a separate rule for ships and aircraft. The IHT/CGT situs rules are also different for such assets.

14.13.2 *Leasing as part of trade*

If the leasing is a trade, then the income is trading income and the source is the trade not the assets of the trade. The question whether the trade is partly carried on inside the UK can be addressed looking at wider factors than just where the asset is situate. But in practice it is suggested that the situs of the assets will often be determinative (unless the trade involves assets situate in more than one country).[43]

41 [1990] STC 733 at p.740b.
42 [1992] STC 723 at p.729e.
43 See 14.8.1 (Situs of assets sold).

14.13.3 *When is chattel leasing a trade?*

Finance Leasing Manual provides:

> **20.10. Schedule D Case I: whether trading**
> In general, where chattels are leased, it should be accepted that the leasing is by way of trade. In exceptional cases, however, where the evidence of trading is extremely slight, for example if only one asset has been acquired for leasing and there is no personal involvement by the taxpayer or any semblance of a trading organisation, the taxpayer's activities are more likely to be in the nature of an investment, with the income assessable Case VI, than trading. Case I treatment should not be refused where, although there is no personal involvement by the taxpayer, there is trading activity by a manager as agent for the taxpayer.

14.14 Research division and shop windows

The ITH provides:

> **827. Profit producing activities**
> Early in this chapter (ITH811) an illustration was given of the hypothetical maker of refrigerators making them in various places in the world and selling them in those places. One way of describing the split of that trade is as a vertical split with a vertical slice here and other similar vertical slices in other countries. We would wish to tax only the vertical slice of the trade carried on here. The other way in which a trade may be split may be thought of as horizontal, the sort of situation we have just discussed, one horizontal slice of the trade, manufacturing say, being here and another slice, the selling, abroad.

The horizontal/vertical terminology seems strange, The metaphor is also used in competition law but the other way round.[44] The ITH continues:

> The above cases are straightforward enough but difficulty starts to

44 "Vertical agreements" are those made between two or more undertakings each of which operates at a different level of the production or distribution chain. Horizontal agreements are those made between undertakings operating at the same level of the production or distribution chain, covering for example research and development, production, purchasing or commercialisation. See Regulation (EC) no. 2790/1999.

> emerge when what is done here is not clearly identifiable as part of the whole trade in that way. An example is the non-resident stock-broker with a branch in London which merely puts the goods in the shop window.

"Shop window" is another unhelpful metaphor. What does it mean? The ITH explains:

> There may be a research section here with computers and the other paraphernalia of a modern trade of that sort. The branch gives advice to would be customers and when they decide to buy a particular American stock, it tells its head office in New York and there the actual deal is done. If the London branch really is only a shop window and really does take no part in the contracting process then the conclusion is that that is not trading within the UK; there is only one trade which is providing the service of buying or selling stocks and that is done in New York. It is quite possible for a non-resident trader to have an office here employing a substantial number of people and yet not to be exercising the trade here.
> Another example might be the manufacturer on a very large scale in America, which has a research division in this country. The work of the research division may be absolutely vital to the trade but if that trade consisted for example in the making and sale of television sets, one could not say that research on, let us say, conductivity constituted a distinct profit producing part of that trade. That is reasonably clear.

This is right because it is difficult to allocate the profits, so they should be regarded as merely auxiliary.[45]

> More difficult is the position of non-resident banks or insurance companies which use the UK for their investment activities but do not carry on the business of banking or insurance here. The questions in this whole area of "trading in" are mainly those of fact and degree and absolute guidelines are simply not possible. International Division will be glad to help in cases of doubt.

14.15 Trading in UK: preparatory and auxiliary activities

The ITH Manual para 849 provides that activities within OECD Model Convention para 5(4) do not amount to trading in the UK. Para 5(4) provides:

45 See 14.15 (Trading in UK: preparatory and auxiliary activities).

Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparas a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

For HMRC Manual discussion, see 64.7 (PE: preparatory and auxiliary activities).

14.16 Where is contract made?

If or to the extent that the place where is the contract made is an important factor, that place has to be identified. The place where a contract is made is, fundamentally, a question of contract law. But the identity of the place where the contract is made is not relevant for the purposes of contract law, so there are no contract law cases discussing the issue. In the reported tax cases the place where the contract was made was fairly obvious, and so the cases do not help us here. We are thrown back to first principles.

Going back to first principles, a contract in English law[46] is made by acceptance of an offer. The contract takes effect on acceptance and the place where the contract is made is where the acceptance takes place. As a general rule, acceptance takes place when the acceptance is received by the person who makes the offer. There are, however, exceptions to this:

46 Further consideration is needed if the applicable law is not English law.

(1) Acceptance by post–acceptance takes place when and where the letter of acceptance is posted, not where received (unless the offer otherwise provides).
(2) When an offer is made, one can specify in the terms of the offer how and when it can be accepted, and this can therefore alter the place where the contract is made.

Offer and acceptance can be difficult to identify. The court will try to impose an offer and acceptance analysis on circumstances which may not lend themselves to that analysis.[47]

There is no case law on email acceptance.[48] The person making the offer can decide how that offer is accepted so if the documentation is correctly drafted a contract can be made abroad by the click of a mouse outside the UK.

ITH discusses this issue:

> **The making of a contract**
> **830. General**
> There have been many references in this chapter to the making of a contract and to the place where a contract is made. If two people agree specifically on a sale by word of mouth that is the making of a contract and the place of their agreement is the place where the contract is made. A great deal of business is done in that way daily and the place of contract is not changed by the signing of a piece of paper in a tax haven sometime afterwards. The difficulty is one of proof as we have already seen in ITH822. But putting difficulties of that sort on one side, if the question where a contract is made becomes of central importance it is one on which we should rely on legal advice – it is pre-eminently a question for the Solicitor and what follows is very general guidance.

47 Some academic writers have suggested abandoning the "offer and acceptance" analysis and replacing it by a contract theory based on reliance. (There is more than a hint of this in Lord Denning's judgment in *Gibson v Manchester City Council*. This decision was reversed by the House of Lords but even Lord Diplock accepted that there would be times when offer and acceptance would be difficult to identify and the "normal analysis of a contract as being constituted by offer and acceptance" might not be appropriate. However that would be exceptional. See [1979] 1 WLR 294 at p.297.)

48 The Law Commission paper (Electronic Commerce: Formal requirements in commercial transactions, December 2001) does not deal with the issue of where a contract made by email is made.

831. Acceptance of offer

Offer and acceptance constitute contract. The place of contract is governed by the place of acceptance of the offer and acceptance takes place where it is received. Where acceptance is communicated by letter it is regarded as received at the place of posting rather than at the place of actual receipt. This is because, once a letter has been posted, the Post Office holds it on behalf of the addressee. Where telephone communication is used the place of acceptance is the place where the recipient of the acceptance is. That is the general rule for so-called instantaneous communication. It would apply also to an acceptance sent by telex or fax directly from the acceptor's office to the offeror's office. The general rule may need qualifying when a cable company's services are used. A telegram like a letter is regarded as received when put into the hands of the Post Office.

832. Price lists

The mere sending out of price lists and advertisements does not constitute an offer, it is rather an open invitation for offers to be made. An offer must be quite specific and a price list is not an offer to supply an unlimited amount of goods at the price named. It follows that when a customer buys goods from a supplier the customer makes the offer and the supplier notifies acceptance. That is generally the assumption in cases where place of contract has been decisive in determining a non-resident's liability. But it is not impossible for a price list to amount to an offer, as long as the list details the price, the quantity and gives a definite description of the goods concerned. If in such circumstances the buyer were to put in some amendment not contained in the original offer, then what the buyer does becomes a fresh offer and one which has to be unconditionally accepted before there can be said to be a binding contract. And there may be a series of communications between customer and supplier so that it is a matter of chance as to who makes and who accepts the final offer.

833. Delivery

It is quite common to find that there is no formal acceptance of the offer by the person supplying the goods and, in that situation, delivery itself will normally constitute acceptance; and then it would be important to look at the place of delivery, the place where the lawful property in the goods passes from seller to buyer.

834. Acceptance by agent

There can be widely different circumstances in which contracts are made here. There is the case where the agent or branch in this country really does the job of negotiating the contract. That person settles the deal and terms and makes the contract here and there is no doubt whatever about it. On the other hand, there can be the case where the agent makes the contract in the legal sense, but does so only with the specific authority of the principal. That is to say the agent gets an offer, writes to or rings the principal, obtains approval and then, and only then, accepts the offer. In that case, acceptance would be here and there are at least two cases [For example, *Wilcock v Pinto & Co* 9 TC 111] on that point.[49]

49 There is also a brief comment (not worth setting out here) in NI Manual 29013.

14.17 Trade partly in UK: apportionment

I turn to the question of how to apportion where part of the trade is in the UK. Of course this overlaps with the question of whether there is a trade partly in the UK. If there are activities in the UK which do not involve trading in the UK there is nothing to apportion.

Tax Bulletin 18 provides:

> It is perhaps less obvious how the profits from the part of the trade carried on in the UK should be measured. They are required to be measured on the arm's length principle set out in the [OECD model tax convention] where a DTA applies which includes the relevant provisions. It is considered that it also follows from the main rule in Schedule D that the same principle applies even if there is no treaty.
>
> There is support for this principle in the early tax cases on non-residents trading in the UK. For example, in *Pommery & Greno v Apthorpe* at 2 TC 189, Denman J said, with regard to the profits chargeable in the UK from merchanting champagne produced in France, that:
>
> > It may be that there may be some difficulty in some respects as to the manner of calculating the amount of expenditure to be put against the profits, whether it would be a proper course to look at the goods sent over to England and then to consider what profit they make, putting a fair valuation on them as they arrive, and as the money is transmitted, or whether it would be necessary in such a case to look more minutely into the profits and losses upon the whole trade carried on partly in France and partly in England. I do not think it is necessary at all at this stage of the case to decide that. That is a matter of quantum, a matter for the consideration of persons skilled in dealing with such matters as assessing profits of trade.
>
> This can be seen as an early description of the arm's length principle and as a recognition of the need to develop methods to apply that principle in practice. Such methods were developed in the OECD 1979 Report on "Transfer Pricing and Multinational Enterprises" and have been reaffirmed and clarified in the recently published 1995 revision of that report by OECD "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations".[50]

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50 [Author's Note] A précis of this passage is set out in ITH para 857. For a more up-to-date discussion, see "The Attribution of Profit to Permanent Establishments" ed. Russo, IBFD 2005 and OECD Report on the Attribution of Profits to Permanent

ITH also touches on this issue:

> **814. Measure of profit in *Erichsen v Last***[51]
> The second point the case deals with is – what is the chargeable profit? That is a rather special point where the transmission of messages is concerned. What the company claimed was that a great deal of the profit arose from the transmission over cables which were not here at all. The Master of the Rolls gave a simple parallel example of a foreign company running a steam packet between Dover and Calais. He said that as far as carrying passengers from Dover to Calais was concerned that was trading in Dover. There was no need to look at the three mile limit or anything of that sort. One simply had to take the receipts and deducts the expenses. The journey started here and the service was here. That is an idea limited in its application to trades involving the transmission of passengers, goods and information.

Establishments accessible *www.oecd.org/dataoecd/55/14/37861293.pdf*.

51 [Author's Note] For facts of *Erichsen v Last* see ITH 813, set out in 14.4 (Place where contract made).

CHAPTER FIFTEEN

PROPERTY INCOME

15.1 Property income - Introduction

ITTOIA uses the term "**property income**" to mean income from land.[1] The taxation of property income is governed by Part 2 ITTOIA. A full discussion requires a book to itself. This chapter focuses on the questions which most affect foreign domiciliaries.

I do not consider the position of UK resident companies (subject to CT rather than to IT).

I do not consider deduction of tax at source and UK agents, under the non-resident landlord regulations (on which HMRC have written 88 pages of guidance notes) though I would like to cover this in a future edition.

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1 A note on terminology. The commentary to TLR Exposure Draft No. 13 provides:

> "*Finding a suitable name*
>
> 223. Letting income has long been referred to as "Schedule A income" by tax professionals. But that is not an informative label for the non-specialist and we are removing references to the Schedules.
>
> 224. We considered several possible new names for this type of income including "land income", "letting income", "rental income", "property business income" and "property income". We concluded that "property income" offered the best compromise because:
>
> - it matches the names that are proposed for the other types of income: "trading income", "employment income" and "savings and investment income";
> - for most people, it is likely to appear the most appropriate name; and
> - it links directly with what we think is the most appropriate name for the business activity ("property business"): "land business" and "rental business" might be particularly misleading.
>
> 225. The disadvantage is that it might appear to go wider than income just from land; that is, strictly, "property" means more than just land and buildings. But we do not think that most people will find this confusing as the proposed use corresponds broadly to the popular use."

I do not consider the special reliefs relating to UK furnished holiday accommodation, but note that the restriction of these reliefs to property in UK is in breach of EU law, and so they should be applicable to property in any member state.

15.2 Property income terminology

15.2.1 *"UK property business"*

Section 264 ITTOIA provides:

> **264 UK property business**
> A person's UK property business consists of—
> (a) every business which the person carries on for generating income from land[2] in the UK, and
> (b) every transaction which the person enters into for that purpose otherwise than in the course of such a business.

At first sight (b) is puzzling. ITTOIA EN explains why it is there:

> 1049. … the concept of the "property business" is, to a certain extent, an artificial one. Unlike the term "trade" it may not always correspond to an activity organised in a way that the proprietor would necessarily describe as a business. As such, the term has to cover:
> - "real" businesses where the lettings are organised in a professional way;
> - lettings which are not so organised; and
> - casual and one-off transactions which may have very little of the qualities normally associated with a business.
>
> Then all of these lettings of different types must be treated as part of the same, single business.

15.2.2 *"Overseas property business"*

ITTOIA continues:

2 The expression "generating income from land in the UK" is defined in ss.266, 267 ITTOIA.

265 Overseas property business
A person's overseas property business consists of—
(a) every business which the person carries on for generating income from land outside the UK, and
(b) every transaction which the person enters into for that purpose otherwise than in the course of such a business.

ITTOIA EN explains:

1056. The definition is identical to that of "UK property business" except that the land from which the income arises is outside the UK. That is the only difference between a UK and an overseas property business: income from land outside the UK can arise only in an overseas property business; income from land in the UK can arise only in a UK property business.
1057. For the purpose of deciding whether there is an overseas property business, overseas land law is interpreted in accordance with section 363.

See 15.4 (Losses of overseas property business) for a refinement to this definition.

15.2.3 *"Property business"*

Section 263(6) provides a commonsense definition:

In this Act "property business" means a UK property business or an overseas property business.

15.3 Taxation of income from property business

The charging provisions are in Chapter 3 Part 3 ITTOIA. Sections 268–270 provide:

268 Charge to tax on profits of a property business
Income tax is charged on the profits of a property business.
269 Territorial scope of charge to tax
(1) Profits of a UK property business are chargeable to tax under this Chapter whether the business is carried on by a UK resident or a non-UK resident.
(2) Profits of an overseas property business are chargeable to tax under

this Chapter only if the business is carried on by a UK resident.

270 Income charged

(1) Tax is charged under this Chapter on the full amount of the profits arising in the tax year.

(2) Subsection (1) is subject to Part 8 (foreign income: special rules).

Section 270(2) ITTOIA feeds into s.832 which incorporates the remittance basis rules.

15.4 Losses of overseas property business

15.5 *Losses from 2008/09*

Chapter 4 Part 4 ITA provides loss relief for a property business. There are three classes of loss relief:

(1) Carry forward against subsequent property business profits: s.118–119 ITA.

(2) (a) Capital allowance losses and
(b) agricultural estate losses.
Sections 120–124 ITA.

(3) Post-cessation property relief: s. 125–126 ITA.

In this chapter I consider only the first of these reliefs. Section 118 ITA provides:

Carry forward against subsequent property business profits

(1) Relief is given to a person under this section if the person—

(a) carries on a UK property business or overseas property business (alone or in partnership) in a tax year, and

(b) makes a loss in the business in the tax year.

(2) The relief is given by deducting the loss in calculating the person's net income for subsequent tax years (see Step 2 of the calculation in section 23).

(3) But a deduction for that purpose is to be made only from profits of the business.[3]

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3 For completeness, the ITA continues:
"(4) In calculating a person's net income for a tax year, deductions under this section from the profits of a business are to be made before deductions of any other reliefs from those profits.

The Property Income Manual correctly summarises:

> **4705 Losses**
> As part of the changes made by FA 1995, the taxable profits and losses of overseas let property were ring fenced for IT purposes. The effect was that:
> - losses of an overseas property business cannot, for IT purposes, be set against profits of a UK property business carried on by the same individual,
> - similarly, losses of UK property business cannot for IT purposes be set against profits of an overseas property business carried on by the same individual.

The definitions of UK property business and overseas property business in ITTOIA were only ITTOIA-wide definitions (they do not apply for all the income tax Acts) so the drafter of the ITA had to repeat them. Section 989 ITTOIA extends them to the income tax Acts:

> The following definitions apply for the purposes of the Income Tax Acts—
> "overseas property business" has the meaning given by Chapter 2 of Part 3 of ITTOIA 2005,
> "UK property business" has the meaning given by Chapter 2 of Part 3 of ITTOIA 2005

At this point we need to consider s.263(4)(5) ITTOIA which restricts the meaning of "overseas property business":

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(5) No relief is to be given under this section so far as relief for the loss is given under section 120.
(6) This section needs to be read with section 119 (how relief works).
119 How relief works
This section explains how the deductions are to be made.
The amount of the loss to be deducted at any step is limited in accordance with section 25(4) and (5).
Step 1 Deduct the loss from the profits of the business for the next tax year.
Step 2 Deduct from the profits of the business for the following tax year the amount of the loss not previously deducted.
Step 3 Continue to apply Step 2 in relation to the profits of the business for subsequent tax years until all the loss is deducted."

(4) References in this Act to an overseas property business are to an overseas property business so far as any profits of the business are chargeable to tax under Chapter 3 (as to which see, in particular, section 269).
(5) Accordingly, nothing in Chapter 4 or 5 is to be read as treating an amount as a receipt of an overseas property business if the profits concerned would not be chargeable to tax under Chapter 3.

I refer to this provision as **"the non-chargeable overseas property business rule".** This rule applies for the purposes of "this Act" (ITTOIA). However is suggested that this applies for the purposes of loss relief in the ITA, s.989 ITA incorporates the s.263 rule, because it incorporates the definition of Chapter 2 Part 3 ITTOIA, and s.263 is in Chapter 2.
Suppose T carries on an overseas property business and:
(1) Year 1: T is non-resident and realises losses;
(2) Year 2: T is UK resident and realises profits.
The losses of Year 1 are disallowed since the profits of that year are not chargeable under Chapter 3 (or at all) so there is no overseas property business. In short, losses of non-residents are not relievable. *Quaere* whether this would apply if T were resident in an EU member state.

What about an overseas property business carried on by a remittance basis taxpayer? An overseas property business which is taxed under the remittance basis is (from 2008/09) taxed under Chapter 3 (even though the amount of income taxed is determined by s. 832 ITTOIA which is not in chapter 3.) So the non-chargeable overseas property business rule does not disallow loss relief. Presumably this change was intentional as it was not desired to introduce an equivalent of the incomprehensible CGT loss rules into this context.[4]

15.6 *Losses before 2008/09*

The position was different before 2008/09. This is still relevant in relation to the question of whether pre-2008 losses can be carried forward and set against post 2008 profits. The relevant legislation in ITTOIA provided:

268 Charge to tax on profits of a property business
Income tax is charged on the profits of a property business.

4 See 40.08 (Loss accruing to remittance basis taxpayer).

269 Territorial scope of charge to tax
(1) Profits of a UK property business are chargeable to tax under this Chapter whether the business is carried on by a UK resident or a non-UK resident.
(2) Profits of an overseas property business are chargeable to tax under this Chapter only if the business is carried on by a UK resident.
(3) But, in the case of an overseas property business carried on by a UK resident to whom the remittance basis applies, the only profits of the business chargeable to tax under this Chapter are those in respect of land in the Republic of Ireland.
(4) For a UK resident to whom the remittance basis applies, see also Chapter 11 (charge to tax on overseas property income other than income arising in Republic of Ireland).

(Words in italics repealed by the FA 2008.) Thus for a remittance basis taxpayer, and ignoring the special case of land in Ireland,[5] the charge was not under Chapter 3. Instead it was in Chapter 11 (also repealed in the FA 2008). This provided:

357 Charge to tax on overseas property income
Income tax is charged on the overseas property income of a person to whom the remittance basis applies.
358 Meaning of "overseas property income"
In this Chapter "overseas property income", in relation to a person to whom the remittance basis applies, means amounts which
(a) are not brought into account in calculating the profits of any overseas property business of the person, but
(b) would be if section 269(3) (charge to tax on profits of an overseas property business of a person to whom the remittance basis applies only in respect of land in the Republic of Ireland) were omitted.
359 Income charged
Tax is charged under this Chapter on the amount specified by section 832 (relevant foreign income charged on the remittance basis).

So before 2008, the remittance basis taxpayer did not have an "overseas property business" so there could not be loss relief. In the 2007/08 edition of this book I commented:

5 I do not discuss Irish property income here, but note that the pre-2008 legislation was in breach of EU law; see 9.23 (RFI from Ireland).

> This is consistent with the CGT treatment of losses. It may be desirable for a foreign domiciliary not to claim remittance basis treatment in the year that a loss accrues in order to obtain that loss relief. Though the cost of that claim must be set against the benefit of the remittance basis in that year.
> Suppose the loss is allowable in the year it accrues but in a subsequent year the owner claims remittance basis treatment. The loss is not allowable in that year. However, it is suggested that the loss can be carried forward and set against profits of other years if the arising basis applies to those years.

It is suggested that a loss which did not qualify for relief in the year that it accrued cannot be carried forward to 2008/09 or subsequently. HMRC may well agree. The Property Income Manual provides:

> **4702. IT cases up to 2004-05** [February 2007]
> No loss can ever arise on income taxed on the remittance basis.

Offshore property business losses from before 1998/99 are allowable under ESC B25, but it seems unlikely that any such losses will still be available to be carried forward to the present time.

15.7 Border between trading income and property income

Section 261 ITTOIA provides:

> **261 Provisions which must be given priority over Part 3**
> Any receipt or other credit item, so far as it falls within—
>
> (a) Chapter 3 of this Part so far as it relates to an overseas property business or Chapter 8 or 9 of this Part (rent receivable in connection with a UK section 12(4) concern or for UK electric-line wayleaves), and
> (b) Chapter 2 of Part 2 (receipts of a trade, profession or vocation),
> is dealt with under Part 2.

ITTOIA EN explains:

> 1058. The priority rules in the trading income Part of this Act (section 4) make it clear that a charge under Part 3 of this Act as UK property income has priority over a charge under Part 2 as trading income. This

reflects the rule in Schedule D Case I (section 18(3) of ICTA). The sort of receipt to which this rule might apply is rent received by a property developer from the temporary letting of land awaiting development. The rent is taxed as property income, even if it could properly be regarded as a trade receipt.
1059. In the case of a foreign trade and foreign property, the rule in section 65A(1)(b) of ICTA is the reverse of that in section 18(3) of ICTA. An overseas property business does not include "income to which section 65(3) of ICTA applies (income immediately derived from carrying on a trade ..)". So the priority rule in section 261 preserves this position

I do not understand the reason for preserving this anomaly.

15.8 Credit for foreign tax

The Property Income Manual provides:

4703. IT cases for 2005-06 onwards [February 2007]
Credit for foreign tax
If the overseas income has suffered foreign tax and a claim to tax credit relief is made, it will be necessary, for the purposes of the source by source rule (see INTM161210) to identify the amount of UK tax attributable to income from each particular property. Where, therefore, tax credit relief is claimed separate computations of profits and losses for each property will be required. For the purposes of calculating tax credit relief, losses should be deducted in the order most favourable to the company's claim. Normally this will mean that losses should be allocated first against the source which has suffered at the lowest rate of foreign tax.
A company's flexibility in deciding how to allocate the deduction set out in Section 797(3) ICTA 1988, subject to the limitations in respect of deficits on non-trading loan relationships set out at Section 797(3)(A) and (B) ICTA 1988, is unaffected by any of the changes.

CHAPTER SIXTEEN

SETTLOR-INTERESTED TRUSTS

16.1 Settlor-interested trusts – Introduction

Chapter 5 Part 5 ITTOIA contains a code of anti-avoidance provisions known as the Settlement Provisions. The most important is s.624(1) ITTOIA which provides:

> **Income where settlor retains an interest**
> (1) Income which arises under a settlement is treated for income tax purposes as the income of the settlor and of the settlor alone if it arises—
> (a) during the life of the settlor, and
> (b) from property in which the settlor has an interest.

On the definition of "settlor": see 58.1 (Who is the settlor?). "Settlement" for this purpose means settlement-arrangement; see 58.2 (Definitions of Settlement).

For the interaction with the chargeable event regime: see 22.7 (Section 624 ITTOIA and chargeable event gains). For offshore funds, see 23.12.2 (UK resident settlor-interested trust) and 23.14 (OIG accruing to non-resident trust). For the accrued income scheme, see 25.13 (Settlor interested trusts). See too 34.5 (Settlor-interested trust: rates of tax on settlor).

16.2 Meaning of "income arising under a settlement"

Section 648(1) ITTOIA provides:

> References in this Chapter to income arising under a settlement

include— [1]

(a) any income chargeable to income tax by deduction or otherwise, and
(b) any income which would have been so chargeable if it had been received in the UK by a person domiciled, resident and ordinarily resident there.

The points made in 17.14 (The amount of income of person abroad) and 17.13 (Capital receipts deemed to be income) apply also for the purposes of ascertaining what is the "income arising under a settlement".

16.2.1 *Income of company, unit trust or partnership held by trustees*

In this discussion income arising to a company held by trustees (not arising to trustees directly) is called "company income". Company income is not "income arising under a settlement". This follows from the repeal by Sch 17 FA 1989 of s.681(2)(b) ICTA (which formerly brought company income into the scope of that expression).[2] This view is also supported by reference in the definition to "income chargeable to *income* tax". Company income would normally be chargeable to corporation tax.

It is considered that income of a unit trust held by trustees is similarly not "income arising under the settlement", (unless the unit trust is transparent in which case its income passes through to the trustees.)

It is suggested that the position is different where trustees have an interest in a partnership. Insofar as income is distributed by the partnership to the trust it obviously constitutes income arising under the settlement. But even if income is retained by the partnership, it is still income of the trustees since a partnership is transparent for IT.

Income which is not income arising under the settlement may instead fall within s.720 ITA.

16.2.2 *Income of life tenant (not the settlor)*

Income payable under the trust to a life tenant is "income arising under a settlement". Admittedly, such income is usually regarded for tax purposes

1 The context suggests this is an exhaustive definition, i.e. the word "include" really means "mean".

2 This was part of the repeal of the close company apportionment provisions.

as the income of the life tenant, not of the trustees.[3] But that is not relevant here, because:

(1) the expression is "income arising under the settlement", not "income accruing to trustees"; and
(2) "settlement" is very widely defined: see 58.2.3 (Settlement-arrangement).

This can be seen to be the case by considering a trust made by S, revocable by S, under which income is payable to B for life. It could hardly be argued that such income falls outside the scope of s.624 ITTOIA.

16.2.3 *Income of life tenant settlor*

Where the settlor has an interest in possession, trust income actually received by the settlor is not within s.624 ITTOIA. It is subject to income tax under general principles.[4] But from 2006/07 the rates of tax are the same in either case,[5] so the issue does not now arise.

16.2.4 *Property business income*

Property Income Manual 1045 [February 2007] discusses how one calculates property income for the purposes of the Settlement Provisions:

> Various special provisions may apply to trusts and to those who set them up (the 'settlor'). In particular, there is a rule to prevent tax avoidance which can treat trust income as being, for tax purposes, the income of the settlor. Such income is taxed on the settlor under section 619(1) ITTOIA. Where the income is property income, the normal property income rules apply in calculating the income. (Section 623 ITTOIA).

This is correct. It follows that interest paid by the trustees is in principle deductible in computing the quantum of property income for s.624

3 See 10.16 (Income from interest in possession type trusts: identifying the source).
4 The point was discussed in the 4th ed. of this book at 11.4.3. Trust income not received by the life tenant settlor is within s.624 ITTOIA. That applies to income used for trust expenses and income for tax purposes which is capital for trust law purposes.
5 See 34.5 (Settlor-interested trust: rates of tax on settlor).

purposes.

16.2.5 *Property business losses*

The Property Income Manual then considers the treatment of losses:

> The more common case is where the trustees carry on the rental business but the settlor is caught by Section 619(1). Under these circumstances the settlor can't set any trust rental business losses against personal rental business income.
>
> Similarly the settlor can't merge personal rental business losses and the trust rental business profits which are deemed to be the settlor's income and charged under Section 619(1). Thus:
>
> - Where the trustees have a rental business loss and the settlor has a personal rental business profit, the trust loss is carried forward and the settlor is taxed on their personal rental business profit; the amount of the trustees' rental business profit charged on the settlor in the following year under Section 619(1) will be reduced by the trust loss carried forward.
> - Where the trustees have a rental business profit and the settlor has a personal rental business loss, the settlor is taxed on the trust rental business profit under Section 619(1); the settlor's personal rental business loss can't be merged with the trust profit; but, as a separate matter, the settlor may in some cases be able to set a personal rental business loss sideways against other income, including any Section 619(1) income deemed to arise from the trustees' rental business; see PIM 4205.
>
> The position is different where the taxpayer is:
>
> - the settlor; and
> - the life tenant; and
> - carries on the rental business.
>
> Under these circumstances the settlor can merge their personal property losses with the deemed income from the trust and vice versa.

This is thought to be correct. See too 15.4 (Losses of overseas property business).

16.3 Meaning(s) of "settlor-interested"

16.3.1 *The concepts of "settlor-interested"*

The term "settlor-interested", first coined in the FA 2000, is used in connection with various provisions of which the most important are:

(1) The IT settlement provisions (discussed in this chapter).
(2) Section 86 TCGA.[6]

Consistent with the patchwork nature of UK tax, these provisions have significant differences, though they share a common framework. "Settlor-interested" is a convenient label, but not a wholly accurate one.

16.3.2 *"Settlor-interested" for IT purposes*

Subject to minor exceptions not discussed here, s.625(1) ITTOIA provides:

> A settlor is treated for the purposes of section 624 as having an interest in property if there are any circumstances in which the property or any related[7] property—
> (a) is payable to the settlor or the settlor's spouse or civil partner,
> (b) is applicable for the benefit of the settlor or the settlor's spouse or civil partner, or
> (c) will, or may, become so payable or applicable.

In practice the settlor and spouse are usually expressly included as a beneficiary or expressly excluded.[8]

If an individual lends interest free (or at a low rate of interest) to a trust, the HMRC view is that the trust is settlor-interested as the settlor may benefit by repayment of the loan (even if he is otherwise excluded):

> In *Jenkins v IRC* (26 TC 265) the Court of Appeal found that the making of an interest-free loan brought the settlement into what is now [s.624]. In the *Jenkins* case, the dispute was about whether certain income

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6 See 37.6 (Settlor-interested condition). Other examples, not discussed in this book, are s.169F TCGA (restriction of holdover relief for settlor-interested trusts); sch 4A TCGA (disposal of interest in settlor-interested trusts). In addition, "power to enjoy" for s.720 ITA is a similar concept, with a different label. GWR is a comparable but not identical concept.

7 "Related property" is defined in s.625(5) ITTOIA:
> In this section "related property", in relation to any property, means income from that property or any other property directly or indirectly representing proceeds of, or of income from, that property or income from it.

8 For further discussion see *Drafting Trusts & Will Trusts*, Kessler and Sartin, 9th ed., Chapter 13.

> received by the trustees of the settlement could be assessed on the settlor under the provisions of FA 1938 s38(4). That provision contained an extended definition of retaining an interest in income that is in similar terms to the definition of retaining an interest in property or derived property found in [s.624].
> The effect of the decision in *Jenkins* was that a settlor who has made an interest-free loan to his/her trust has brought himself or herself within the scope of s38(4), and by implication [s.624] (albeit that there would be no charge unless income actually arose to the trustees).[9]

The contrary is faintly arguable[10] but for practical purposes this should be accepted as correct.

The IT settlement provisions only apply to income from property in which the settlor has an interest. So if the settlor is excluded from part of the trust fund, the IT provisions do not apply to that part.

16.3.3 *Meaning of "spouse"*

Section 625(4) ITTOIA gives the word "spouse" an artificial and slightly narrow meaning:

> In subsection (1) "the settlor's spouse or civil partner" does not include—
> (a) a spouse or civil partner from whom the settlor is separated under an order of a court or a separation agreement,
> (b) a spouse or civil partner from whom the settlor is separated where the separation is likely to be permanent,
> (c) the widow or widower or surviving civil partner of the settlor, or
> (d) a person to whom the settlor is not married but may later marry or a person of whom the settlor is not a civil partner but of whom the settlor may later be a civil partner.

The TAA provisions do not contain the same provision, which is

9 Letter from HMRC to the Association of British Insurers, September 2004, Pre-owned Assets and Tax Planning Strategies, Chamberlain & Whitehouse (2nd Ed. Sweet & Maxwell) p.455. Loans also raise issues under s.633 ITTOIA and s.727 ITA.

10 There is a discussion in the 2nd edition of Taxation of Charities (Venables & Kessler, 1993) p.137.

anomalous, but that is the patchwork nature of UK tax. Fortunately it does not often matter.

16.3.4 *Subsequent exclusion of settlor from the settlement*

If the settlor originally had an interest in trust property but is later excluded (together with his spouse) then s.624 ITTOIA ceases to apply to income arising after the date of the exclusion. If the settlor is excluded from part of the trust fund, then he is within the scope of s.624 only on the income arising from the part in which he still has an interest.

16.3.5 *Transfer to new settlement*

If the trust fund is transferred to a new settlement from which the settlor is not excluded, then s.624(1) ITTOIA continues to apply. The old settlor is the settlor of the new trust.[11]

If the entire trust fund is transferred to a new trust from which the settlor (and spouse) are entirely excluded then s.624 ceases to apply, and if they are excluded from part, it ceases to apply in part.

16.4 Section 624 beneficiary relief

Section 685A ITTOIA avoids a double charge when income of a settlor-interested trust is paid to a beneficiary. I refer to this as **"s.624 beneficiary relief"**.

16.4.1 *Conditions for relief*

Section 685A(1) ITTOIA provides:

> This section applies if—
> (a) a person receives an annual payment in respect of income from the trustees of a settlement,
> (b) the payment is made in the exercise of a discretion (whether of the trustees of the settlement or any other person), and
> (c) a settlor is charged to tax under section 619(1) on the income arising to the trustees of the settlement (whether in the current year of

11 See 58.7 (Transfer from trust A to trust B by exercise of trustees' power).

assessment or in a previous year of assessment) out of which the annual payment is made.

The relief only applies to discretionary trusts. But if a trust confers an interest in possession (not on the settlor) then no relief is needed: the life tenant is not taxable as the income is the trust income of the settlor and of the settlor alone.

Section 685A(2) ITTOIA provides:

> This section applies only in respect of that proportion of the annual payment which corresponds to the proportion of the total income arising to the trustees of the settlement in respect of which a settlor is chargeable to tax under section 619(1).

It is considered that a settlor is not chargeable to tax for this purpose if the s.624 remittance basis applies, so where that relief applies, s.624 beneficiary relief is disapplied. Section 685A(2) may also apply where:

(1) A settlement is partly settlor-interested (because there are two settlors or the only settlor is partly excluded).
(2) A settlement with a non-resident settlor is charged on part of the income (UK source income only).

16.4.2 *Relief for non-settlor-beneficiary*

Section 685A(3)–(6) ITTOIA confers the relief:

> (3) If and in so far as this section applies, the recipient of the annual payment shall be treated for the purposes of this Chapter as having paid income tax at the higher rate in respect of the annual payment.
> (4) But—
> (a) tax which the recipient is treated by virtue of this section as having paid is not repayable,
> (b) tax which the recipient is treated by virtue of this section as having paid may not be taken into account in relation to a tax liability of the recipient in respect of any other income of his...
> (5A) If the recipient of the annual payment is treated by subsection (3) as having paid income tax in respect of the annual payment, the amount of the payment is treated as the highest part of the recipient's total income for all income tax purposes except the purposes of sections 535 to 537 (gains from contracts for life insurance etc: top slicing relief).
> (5B) See section 1012 of ITA 2007 (relationship between highest part

rules) for the relationship between—

(a) the rule in subsection (5A), and

(b) other rules requiring particular income to be treated as the highest part of a person's income.

(6) Sections 494 and 495 of ITA shall not apply in relation to an annual payment if and in so far as this section applies.

EN FB 2008 explains subsections (5A)(5B):

7. The income of a 'settlor-interested' trust is deemed, for the purposes of income tax, to be the settlor's income as it arises.
8. In non settlor-interested discretionary trusts, where income payments are made to beneficiaries, the income constitutes a new source, and is taxed on the beneficiary. The tax paid by trustees is available to the beneficiaries in the form of a tax credit.
9 . In a settlor-interested trust, an income payment to a beneficiary is still a new source of income taxable in the beneficiary's hands. However the tax paid by the trustees of such trusts is treated as paid on behalf of the settlor. Because the settlor has already been taxed on the whole amount, charging the beneficiary to additional tax would result in a form of double taxation.
10. Section 685A ITTOIA 2005 provides that income paid by trustees of a settlor-interested trust to (non-settlor) beneficiaries comes with a non-repayable 'notional' tax credit equal to the higher rate of tax (currently 40 per cent) which covers all the tax liability on that income.
11. However, under current statutory ordering rules income from a trust is charged before savings and/or dividend income. The result is that a beneficiary of such a trust who also has savings and/or dividend income may find that the non-trust income is pushed into higher rates so that more tax is due overall.
12. The measure amends this ordering rule, so that income from a settlor-interested trust is treated within section 1012 ITA 2007 as one of the highest slices of income instead of being treated as part of the lowest slice.
13. The amending legislation backdates the correct position to 6 April 2006 to ensure that those affected are not disadvantaged by the omission.

Two policy points arise from this which ought to raise serious questions about the rule of law in relation to the UK tax system. Firstly the tax system is so complex that it took two years for the error in the FA 2006 to be noticed and corrected. (I confess I did not notice it myself.) Secondly, the error was corrected by casual retrospective legislation.

16.4.3 *Relief for settlor-beneficiary*

Section 685A(5) ITTOIA provides:

> If the recipient of the annual payment is a settlor in relation to the settlement, if and in so far as this section applies the annual payment shall not be treated as his income for the purposes of the Income Tax Acts (and subsection (3) does not apply).

The TSE Manual 4570 [January 2008] provides:

> **Payments to beneficiary other than the settlor**
> ... For 2006-07 onwards the law provides that discretionary payments to the beneficiary are treated as though the beneficiary had paid tax at the higher rate (see TSEM3755). The amount of the actual payment (it is not grossed up) should be shown in the beneficiary's return and it is included in the calculation of that person's total income. The tax credit ensures the beneficiary has no further liability in respect of the payment but it is ring-fenced so that no part of it can be repaid or set against liability arising from any other income of the beneficiary.
> **Payments to the settlor**
> Where you tax the settlor on the income arising to the trust, discretionary payments out of the trust to the settlor are not further taxable. … For 2006/07 onwards discretionary payments made by the trustees to the settlor are taken out of charge by Section 685A(5) ITTOIA.

The legislation distinguishes between non-settlor beneficiaries and the settlor. In the one case the beneficiaries are given a credit, and in the latter case the income is tax free. At first this seems strange, but a reason will emerge.

16.5 Section 624 remittance basis

Section 648 ITTOIA provides a relief which I call "**the s.624 remittance basis**".

This book considers the relief as amended by the FA 2009, which took effect on 22 April 2009. For the position between 6 April and 22 April 2009 the reader should refer to the 2008/09 edition of this work. (If the 2009 Budget had taken place before 6 April, the complication of two different sets of rules during the same tax year would have been avoided.) There was no consultation on the 2009 changes and neither the Budget Notice nor the EN FB offer any explanation.

The legislation uses the clumsy but effective drafting technique of restricting the definition of "income arising under a settlement". That term is defined in a commonsense way in s.648(1)[12] and s.648(3) then provides:

> And if, for a tax year, section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the settlor, references in this Chapter to income arising under a settlement include in relation to any relevant foreign income arising under the settlement in that tax year only such of it as is remitted to the UK (in that tax year or any subsequent tax year) in circumstances such that, if the settlor remitted it, the settlor would be chargeable to income tax.
> (4) See Chapter A1 of Part 14 of ITA 2007 for the meaning of "remitted to the UK etc.
> (5) Where subsection (3) applies the remitted income is treated for the purposes of this Chapter as arising under the settlement in the tax year in which it is remitted.

In short, foreign income qualifies in principle for the s.624 remittance basis if it is not remitted to the UK.

16.6 The s.648 clawback

The charge under s.648(5) is here called "**the s.648 clawback**". The clawback charge arises if two conditions are satisfied:

(1) The income "is remitted to the UK".
(2) We must ask: would the settlor be chargeable to income tax on the remitted income if the settlor remitted it?

In practice this mainly concerns settlor-interested discretionary trusts. Income of a trust where the settlor has an interest in possession is in principle outside the scope of s.624: see 16.2.3 (Income of life tenant settlor).

12 See 16.2 (Meaning of "income arising under a settlement").

16.6.1 *Trustees remit trust income to UK*

Suppose first the simplest case. A settlor ("S") has made a settlor-interested discretionary trust. S is a remittance basis taxpayer. The trustees receive foreign income, so the circumstances of s.648(3) ITTOIA are satisfied. Later the trustees remit the income to the UK (without transferring it to S).

We ask the question: if S remitted the income, would he be chargeable to income tax? In principle S is chargeable to tax on remitted income if he is UK resident when the income arises to the trustees and at the time of remittance.

In short, income which is outside the scope of s.624 ITTOIA because of the s.624 remittance basis *prima facie* falls back within s.624 if it is remitted by the trustees.

Suppose trustees accumulate income and thus it becomes trust capital. That capital is then remitted. It is considered that the s.648 clawback still applies. Its status as income or capital for trust law purposes is irrelevant.[13]

Accordingly trustees of a settlor-interested trust within the s.624 remittance basis should not remit their foreign income to the UK.

16.6.2 *Trustees pay income to beneficiary (not settlor) who remits to the UK*

Suppose now:

(1) Trustees of a settlor-interested discretionary trust pay the income to a beneficiary ("B") (not the settlor) and
(2) B receives the sum out of the UK but remits the sum to the UK.

Is there a s.648 clawback charge? It is considered that there is no tax charge on the remittance. The reason is that what is remitted to the UK is not "such income"; that is, it is not "income arising under the settlement". It loses its nature as "income arising under the settlement" upon payment to B because it becomes the income of B. It would be surprising if there were a tax charge because the settlor may have no way of knowing whether the income is remitted by B.

13 Compare 9.3.5 (Capital/income terminology in remittance basis context).

It can make no difference whether or not B is a relevant person in relation to the settlor.

If B is UK resident, he will instead be subject to tax on the income payment (under ordinary principles or s.731 ITA). (The s.624 beneficiary defence does not apply in this case, if my analysis is correct.)

16.6.3 *Income payment to settlor-beneficiary*

Suppose:
(1) trustees pay the income to the settlor (as his income); and
(2) S remits the income.

This gives rise to a charge under the s.648 clawback. This must be why s.685A is worded differently for settlors and other beneficiaries. The argument above does not apply since the sum paid to S does not become the income of S. This may explain why s.624 beneficiary relief has different rules for the settlor and for other beneficiaries.

The same applies if:

(1) the trustees accumulate the income;
(2) the trustees pay it to the settlor as capital or lend it to the settlor; and
(3) the settlor receives the sum outside the UK but remits the sum to the UK.

Suppose the trustees use the income to repay an existing loan to S. The loan is repaid outside the UK. It is suggested that the income is not remitted, as the settlor's receipt represents the original money loaned, not the trust income.

Suppose the trustees use the income to make a loan to S. This will be caught if the loan is regarded as effectively a transfer of the money loaned. See 10.14.5 (T lends to R).

16.7 Transitional rule for pre-2008 income

Para 86(4) Sch 7 FA 2008 provides (so far as relevant):

> (4) ... in relation to an individual's income and chargeable gains for the tax year 2007–08 or any earlier tax year, section 809L has effect as if the references to a relevant person were to the individual.

This is extended by para 86(4A) inserted with retrospective effect by the FA 2009:

> For the purposes of sub-paragraph (4), section 648(2) to (5) of ITTOIA 2005 (and corresponding earlier enactments) do not apply (so that relevant foreign income which arose under a settlement in the tax year 2007-08 or any earlier tax year is to be treated as income for the tax year in which it arose).

16.8 Avoiding the s.648 clawback

Practical ways of avoiding the clawback charge are as follows:

(1) Give the settlor an interest in possession, so trust income is taxed on the RFI remittance basis, and is outside s.624.[14]
(2) The trustees do not remit any trust funds to the UK and if the trustees pay the income in any form to the settlor, he does not remit that income.
(3) The trustees segregate trust income and trust capital and remit trust capital, not trust income. There is no s.648 clawback charge if trustees remit to the UK a sum which is not income arising under the settlement. (Likewise the trustees may accumulate the income and pay it as capital to the settlor, who may remit it.)

16.9 Non-resident settlor

This book considers the position as amended by the FA 2009, which took effect on 22 April 2009. For the position between 6 April and 22 April 2009 the reader should refer to the 2008/09 edition of this work. (The complication of two different sets of rules during the same tax year should have been avoided.) There was no consultation on the 2009 changes and neither the Budget Notice nor the EN FB offer any explanation.

The legislation uses the clumsy but effective drafting technique of restricting the definition of "income arising under a settlement". That term is defined in a commonsense way in s.648(1)[15] and s.648(2) then continues:

14 See 16.2.3 (Income of life tenant settlor).
15 See 16.2 (Meaning of "income arising under a settlement").

> But if, in a tax year, the settlor is not UK resident, references in this Chapter to income arising under a settlement do not include income arising under the settlement in that tax year in respect of which the settlor, if actually entitled to it, would not be chargeable to income tax by deduction or otherwise because of not being UK resident.

Where the settlor is non-resident, UK source trust income is within the scope of s.624, but foreign income is not. This prevents s.624 applying where it might benefit the taxpayer. Contrast s.720 ITA which does not apply at all unless the transferor is ordinarily resident.

It does not of course matter for the non-resident settlor if trust income is remitted. The s.648 clawback does not apply.

16.10 Income arising to trustees when settlor is non-resident, remitted when settlor is resident

Section 648(5) ITTOIA provides:

> The income is treated for the purposes of this Chapter as arising under the settlement in the year in which it is remitted.

Suppose:-

(1) Income arises to the trustees of a settlor-interested trust while the settlor is not resident.
(2) The income is remitted by the trustees when the settlor is resident.

It seems at first sight that the income is caught as it is treated under the s.648 clawback as arising in the year of remittance. That would, however, be inconsistent with the scheme of s.624, which is to put the settlor in the position he would be in if he had not made the settlement. Income of an individual arising during a non-resident period is not taxable if remitted during a resident period.[16]

The answer is that in these circumstances the s.648 clawback does not apply. Unless the settlor is UK resident when the income arises, he would not be taxed on it when remitted later, even if it had been his income all along.

16 See 9.22 (Income arising when non-resident, remitted when resident).

16.11 Completion of settlor's tax return

The TSE Manual provides at 4575 [January 2008]:

> **2006–2007 onwards**
> The settlor returns all UK source trust income, without deducting management expenses, on the Trusts etc pages. Foreign source income goes on the Foreign pages.

16.12 Taxation of trustees of settlement within s.624

This frustrating topic is outside the scope of this book. For an introduction see "Tax Charge Doubled!" Malcolm Gunn, *Taxation* 22 February 2007.

16.13 Taxation of life tenant (not settlor) of settlor-interested settlement

Suppose a settlor-interested settlement under which a beneficiary ("B", not the settlor) has an interest in possession. Income within s.624 ITTOIA is treated as the income of the settlor and of the settlor alone, so that B cannot be taxable on it. B is in principle taxable on income not within s.624, that is, income within the s.624 non-residence or s.624 remittance basis.

16.14 Settlor's indemnity

Section 646 ITTOIA provides:

> **Adjustments between settlor and trustees, etc**
> (1) A settlor is entitled to recover from—
> (a) any trustee, or
> (b) any other person to whom the income is payable in connection with the settlement,
> the amount of any tax paid by the settlor which became chargeable on the settlor under section 624 or 629.

For the tax implications see 19.4.10 (Reimbursement of tax under statutory indemnity); 19.20 (Relevant income used to pay expenses) and 58.21 (Failure to exercise right of reimbursement).

16.15 Section 624 ITTOIA *v.* s.720 ITA: comparison and priority

Sections 624 ITTOIA and 720 ITA cover some similar ground. For a full comparison one would need to read all the relevant chapters in this book. It may be helpful to summarise the major differences:

Section 624	**Section 720**
Applies to trusts	Applies to non-resident trusts *and companies*
No motive defence	Motive defence
Settlor indemnity	No indemnity for transferor
Applies generally	Applies to *ordinarily* resident transferor

The rates of tax are slightly different, a (probably accidental) result of the FA 2006.[17]

Where both s.720 ITA and s.624 ITTOIA apply (or appear to apply), which has priority? It must be one or the other: the settlor/transferor cannot be taxed twice on (effectively) the same income. Section 720 originated in 1936, s.624 originated in 1938. But there is no reason why that distant historical priority should determine the issue. Income within s.624 is treated as income of the settlor "*and of the settlor alone*". Section 720 lacks those additional words. So it is considered that s.624 has priority over s.720. Where s.624 applies, the transfer of asset conditions are not satisfied, because if the income is that of the settlor alone, it is not the income of the person abroad.

16.16 Settlor receives capital sum

Section 633 ITTOIA provides:

> (1) Any capital sum paid directly or indirectly in any tax year by the trustees of a settlement to the settlor is treated for income tax purposes as follows.
> (2) The sum is treated as the income of the settlor for the tax year so far as the amount of the sum falls within the amount of income available up to the end of the year.

"Available income" means (in short) income arising under the settlement

17 See 34.5 (Settlor-interested trust: rates of tax on settlor).

which has not been "distributed". Income taxable under s.624 is deducted in computing "available income" so it is not counted twice: see s.635 ITTOIA.

Section 633 is therefore irrelevant to settlor-interested settlements. The settlor either will be taxed under s.624, or (if the s.624 remittance basis applies) the income will not be "income arising under the settlement". Section 633 is only relevant where capital sums are paid to the settlor (or spouse/civil partner) from a trust which is not a settlor-interested trust. Accordingly I shall not discuss the section further here.

16.17 Interaction of s.624 and s.37 TCGA

Section 37(1) TCGA deals with the relationship between IT and CGT:

> There shall be excluded from the consideration for a disposal of assets taken into account in the computation of the gain any money or money's worth
> [a] charged to income tax as income of, or
> [b] taken into account as a receipt in computing income or profits or gains or losses of,
> the person making the disposal for the purposes of the Income Tax Acts…

Thus IT has priority over CGT. The section does not work when s.624 applies as the income is treated for IT purposes as income of the settlor and not the trustees! HMRC solve the problem by a creative application of s.32 TMA. CG Manual para 14304 provides:

> **Sums chargeable as income**
> This exclusion does not apply to … situations where the income in question is not treated as the income of the person making the disposal. Typically this is a case of a settlor interested trust where the income is taxed on the settlor. If in this situation the settlor is assessable to both income tax and capital gains tax then relief may be available under s.32 TMA 1970.

The difficulty is not that the settlor is assessable to IT and CGT. The difficulty is that the settlor is assessible to IT but there is nothing obvious to stop the trustees being assessible to CGT. But relief must somehow be implied.

CHAPTER SEVENTEEN

TRANSFER OF ASSETS ABROAD: INTRODUCTION

17.1 TAA – Introduction

Non-resident trusts and companies pay no UK tax on foreign income. A non-resident company may pay less tax on UK income. These rules present an obvious means of income tax avoidance. HMRC's first answer to this is Chapter 2 Part 13 ITA, entitled "Transfer of assets abroad".

There are strictly three charging provisions – ss.720, 727 and 731 – but for practical purposes there are two, as s.727 is only a minor supplement to s.720. This chapter considers the requirements they have in common. The next two chapters consider them individually.

The discussion of the provisions in International Manual INTM 600000 contains almost nothing significant, but *thirty eight* paragraphs are withheld "because of exemptions in the Freedom of Information Act 2002". Information may be withheld if disclosure would be likely to prejudice the assessment or collection of tax.[1] No doubt parts of the withheld text do fall into that category, identifying tax avoidance possibilities or procedures to detect evasion. I expect that the bulk of the withheld text is simply a discussion of the law. Disclosure only prejudices tax collection if one takes the view that uncertainty in the scope of anti-avoidance law is desirable. This is constitutionally wrong. The principle of legal certainty is an important aspect of the rule of law. (That is the basis on which the Manuals are published in the first place.) It is also pragmatically wrong. Legal certainty is in the interest of HMRC as well as private citizens. If HMRC are not prepared to state their view then

1 s.31(i)(v) Freedom of Information Act 2000. It is interesting to speculate whether some text might actually be withheld because it acknowledges that parts of RI 201 cannot seriously be defended as correct.

private citizens must do as best they can. They can hardly be guilty of neglect if they form wrong views in this difficult area in which HMRC are themselves not prepared to comment, and this is likely to lead to loss of tax. But there it is.

On 31 March 2009 HMRC published some guidance on the ITA remittance basis rules as they apply to the TAA provisions. This is headed TAH (= Transfer of Assets Handbook?) but I call it "**TA Remittance Guidance**").

17.2 "Relevant transfer"

The key concept is "relevant transfer". The charges only apply if a relevant transfer occurs. Section 716(1) ITA provides:

> A transfer is a relevant transfer for the purposes of this Chapter if—
> (a) it is a transfer of assets, and
> (b) as a result of—
> (i) the transfer,
> (ii) one or more associated operations, or
> (iii) the transfer and one or more associated operations,
> income becomes payable to a person abroad.

This sets out the following basic conditions:

(1) *A transfer of assets*.
(2) *Income becomes payable to person abroad*.
(3) *Causation*: Condition (2) is caused by (i) the transfer, or (ii) associated operations, or (iii) both. I refer to this as "**the relevant transfer causation conditions (i), (ii) and (iii)**", or together "**the relevant transfer causation conditions**".

These basic conditions are the subject of this chapter. However the fact that there is a relevant transfer is not sufficient in itself to cause a tax charge. The further conditions in the various charging sections must be satisfied. These are considered in the next two chapters.

17.3 A "transfer" of "assets"

Section 716(2) ITA provides:

> In this Chapter "transfer", in relation to rights, includes the creation of the rights.

If two parties enter into a contract there are *two* transfers of assets as both parties acquire rights.

In *IRC v Brackett* 60 TC 134, T entered into a contract of employment with a person abroad, an offshore company in which he was interested. Rights under a contract of employment are an "asset". Entering into a contract of employment is a "transfer". So T was taxed on all income accruing to the company as a result of the transfer.

If B borrows from L there are two transfers of assets, for B acquires the money borrowed and L acquires a debt. If L is non-resident, then the interest is income accruing to a person abroad.

Note that there may be a "transfer of assets" in circumstances where there is no individual who is the "transferor".

17.4 Person abroad

Section 718(1) ITA provides:

> In this Chapter "person abroad" means a person who is resident or domiciled outside the UK.

17.4.1 *Foreign incorporated company*

Section 718(2) ITA provides:

> For the purposes of this Chapter, the following persons are treated as resident outside the UK—
> (a) a UK resident body corporate that is incorporated outside the UK.

This is otiose because a foreign incorporated company is domiciled outside the UK[2] and so even in the absence of this provision it is within the definition of a "person abroad".

The rule that a UK resident foreign incorporated company should fall within the definition of "person abroad" made sense before the introduction of corporation tax in 1965; until then, a UK resident foreign

2 See 2.17 (Domicile of company).

incorporated company was only taxed on the remittance basis. Since 1965 the rule is not appropriate because a UK resident company pays tax on its profits on an arising basis, even if foreign incorporated, so there is no need for the TAA provisions to apply. However s.3(1) CTA provides:

> **3 Exclusion of charge to income tax**
> (1) The provisions of the Income Tax Acts relating to the charge to income tax do not apply to income of a company if—
> (a) the company is UK resident, or
> (b) the company is not UK resident and the income is within its chargeable profits as defined by section 19.

It is considered that s.720 is a "provision of the income tax acts relating to the charge of income tax" so it does not apply to income of a UK resident company. It is considered that the same applies to s.731.

This makes good sense, because if the profits are subject to corporation tax, HMRC do not need the TAA provisions. This view is also supported by CTA EN:

> **Clause 3: Exclusion of charge to income tax**
> 46. This clause ensures that income of a company within the charge to corporation tax is not chargeable to income tax as well as corporation tax. It is based on section 6(2) of ICTA.

This argument was put in *IRC v Levy* but the judge expressed no view.[3] HMRC do not officially agree,[4] but they may not have considered this point.

One situation in which this issue arises is where a foreign incorporated company is accidentally UK resident, because of a failure to ensure that it is managed and controlled outside the UK. A second situation is where one deliberately uses a UK resident but foreign incorporated company. This may be done in order to obtain the IHT or CGT advantages of foreign situate property.[5] There may however be commercial reasons why it is desired that a foreign incorporated company should be managed and

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3 56 TC 58 at [87]. HMRC's answer was to rely on s.9 ICTA 1988, but I cannot see how that helps. ((Unfortunately the argument was not put in *R v Dimsey & Allen* 74 TC 263, but that should not preclude its being taken now.)

4 See 20.2.1 (Transferor's credit).

5 See 20.2 (Undistributed UK taxable income of offshore company).

controlled in the UK, and the tax system should hardly aim to discourage that. If it were desired to restrict the tax advantages (such as they are) of UK resident foreign incorporated companies, the TAA provisions are certainly not the way to go about it.

It is considered that s. 718(2) should be abolished. If my analysis is right, the subsection is otiose, but if my analysis is wrong, it is undesirable if not pernicious.

17.4.2 *Trustees and PRs*

Section 718(2) ITA provides:

> For the purposes of this Chapter, the following persons are treated as resident outside the UK—
> ...
> (b) the person treated as neither UK resident nor ordinarily UK resident under section 475(3) (trustees of settlements), and
> (c) persons treated as non-UK resident under section 834(4) (personal representatives).

This is otiose because the statutory residence rules for trustees and PRs clearly state when they are regarded as resident outside the UK for IT purposes.

17.5 Income "becomes payable" to person abroad

The condition here is that income becomes payable to a non-resident or foreign domiciled person (the person abroad).

This condition is satisfied where the transfer is to a UK resident and domiciled person who later becomes non-resident or foreign domiciled.[6]

In *Latilla v IRC*[7] a partnership share was transferred to a company abroad which received its share of the partnership profits. It was argued that trading profits could not be described as income *payable* to the company. The House of Lords rejected this argument and held that there was no

6 *Congreve v IRC* 30 TC 163 (a gift to a company which became non-resident), approved on this point in *IRC v Willoughby* 70 TC 57.

7 25 TC 107. I mention for completeness only that this was followed in *Brackett v Chater* 60 TC 143.

difference between trading income and other types of income. It seems amazing today that this technicality was thought arguable, so far has the pendulum swung from literal to purposive construction.

17.5.1 *Transfer from one person abroad to another*

Suppose assets are transferred from one person abroad to another, e.g. from offshore trustees to an offshore company. Can one argue that there is no relevant transfer because one cannot say that income *becomes* payable to a person abroad? It was payable to a person abroad even before the transfer! The argument is linguistically possible, but the context shows that it is wrong. If the argument was right then a transfer by a non-resident or foreign domiciled transferor would never be a relevant transfer, which is certainly not the case.

17.6 Situs of transferred assets

The heading "transfer of assets abroad" might suggest a requirement that UK situate assets must become non-UK situate, but that is obviously not the case.

It has been suggested that the assets must be UK situate at the time of the transfer. This was rightly rejected by the Special Commissioner in *IRC v Willoughby* 70 TC 57 at 79. The taxpayer wisely abandoned this point on appeal.

17.7 Transfer for full consideration

A relevant transfer may be made for full consideration and need have no element of "bounty" or gratuitous intent. (Contrast the settlement provisions.)[8]

17.7.1 *Purchase of asset from person abroad*

Suppose T buys an asset from a person abroad for cash ("the purchase price"). At first glance, the payment of the cash purchase price is a relevant transfer. The payment is a transfer of assets; as a result of the

8 See 58.2.3 (Settlement arrangement).

payment, income (from the cash) will normally accrue to the person abroad. However, it is suggested that this is not the case if:

(1) the asset would otherwise have yielded income to the person abroad;[9]
(2) the purchase price does not exceed the value of the asset.

In these circumstances, the person abroad acquires the income of the cash purchase price T transfers to him, but he loses the income from the asset which he sells to T. If the two (broadly) cancel each other out, it cannot be said that any "income becomes payable" to the person abroad. If that is right, the transfer of asset conditions are not satisfied every time someone sells an asset to (or buys an asset from) a non-resident person. That would be a sensible result. If T sells assets to an offshore trust, say, or to an offshore company, it would be surprising if his only defence to TAA was the motive defence.[10]

17.7.2 *Income arising must be identifiable*

The provisions assume that one can *identify* the amount of income which accrues as a result of the transfer. If that identification is not possible then it is considered that the transfer of asset provisions do not operate.

John Avery Jones raises this question:

> What about buying a ticket from a foreign airline, buying a meal or paying for a hotel room when abroad? There is a transfer of assets and it is clear that "income becoming payable" includes the receipt of sums which form part of the recipient's trading profits. Oh, and there is my IFA subscription, my subscription to *European Taxation*, my purchase of that overpriced new edition of *OECD Model Tax Convention*, and the new edition of *Klaus Vogel on Double Taxation Conventions* direct from the publisher. Foreign entities all of them. I expect if I think for a

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9 This would not of course be the case if T transfers assets to an offshore company in consideration of an issue of shares or debentures or a life policy.

10 In such cases T would often have "power to enjoy". Unless this is right, there is double taxation. T may be liable under s.720 for income tax on the income arising from the asset sold to the person abroad. T is also liable to income tax on income arising from the proceeds which he receives on the sale of the same asset.
If my view is wrong, then the motive defence should be generously applied in cases of a sale for full consideration.

> moment I shall think of lots more. What about my (foreign) car? Did I buy it from an agent for the manufacturer or from a UK subsidiary, and does it make any difference anyway?[11]

These are all transfers of assets, and trading income is payable to the person abroad. But none of these transfers are relevant transfers because one cannot identify the income which becomes payable as a result of them.[12] (An independent reason is that (maybe) no income becomes payable, as discussed above.)

17.7.3 *Deposit in offshore bank account*

If T deposits a large sum with a bank, the trading receipts of the bank are increased, but that is (almost) cancelled by the interest the bank pays to T. There is still a profit overall, if the bank is profitable, but that element of profit cannot be identified. The deposit is a transfer of assets but it is not a relevant transfer because one cannot identify the income which becomes payable as a result of it.

17.7.4 *Transfer for issue of shares or debentures*

Suppose T transfers an asset to a foreign company in exchange for the issue of shares or debentures in that company (set up for the purpose and wholly owned by a trust or structure set up by T). This may well be transfer for full consideration. It is nevertheless a relevant transfer. Indeed it is the archetypal TAA situation. Tax avoidance arrangements set up in the 1920s and 1930s typically involved the transfer of assets to a Canadian company in consideration of debentures issued by that company.

Contrast the position if T subscribes for shares or debentures in (say) a large quoted foreign company or collective investment scheme. This is not a relevant transfer as one cannot identify the income which arises as a result of the transfer.

17.7.5 *Transfer for issue of bond or life insurance policy*

The same applies if T subscribes for a bond or life insurance policy from

11 [1998] BTR 392.

12 Of course in practice considerations of materiality might also arise.

a large foreign institution. One cannot normally identify the income arising to the institution as a result of the transfer so this is not a relevant transfer. However, if the transfer is linked to particular investments actually made by the institution (as is usually the case for a personal portfolio bond), it would in principle be possible to identify the income, and there would be a relevant transfer.

17.7.6 *HMRC view*

EN FB 2006 states:

> The [transfer of asset] provisions do not affect an individual's personal direct offshore investments. They only apply where an individual is able to enjoy income in a form that would otherwise be non-taxable (or subject to a lower rate of taxation), and there is a purpose to avoid UK tax. So the legislation would not apply where, for example,
> [1] a UK resident invests directly in an offshore bank account or
> [2] buys shares in a company quoted on an overseas stock exchange,
> because the income arising from such investments remains liable to UK tax in the usual way.[13]

Example [1] is the person who invests[14] in an offshore bank account. That person makes a transfer of assets to a person abroad (the bank). It is broadly true that the income from such investments (i.e. bank interest) "remains liable to tax in the usual way".[15] But while this explains why HMRC would not wish to apply s.720 ITA, it does not actually offer any defence to the provisions.[16] (This fact is relevant to the motive defence, but it would be surprising if the only defence to s.720 was the motive defence.)[17] The true reason is that one cannot identify any income of the bank which becomes payable as a result of the transfer, so the transfer is

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13 EN to s.79, para 63.

14 A lawyer would call this a loan or deposit, not an "investment", but nothing turns on that.

15 It is not strictly the case that income from offshore investments "remains liable to UK tax in the usual way". A foreign domiciliary may invest UK funds in a foreign account to come under the remittance basis. Even a UK domiciliary obtains the tax advantage that tax is not deducted at source, and DTT relief may apply.

16 See 18.4 (Must the transferor avoid or intend to avoid IT?)

17 No-one expects the depositor to claim the motive defence in his tax return.

not a relevant transfer.

Example [2] is the person who purchases shares on an overseas stock exchange. The example is wholly misconceived. A person who buys shares does not make a transfer of assets to a person abroad, unless the vendor is abroad; and the fact that the shares are "quoted on an overseas stock exchange", like the flowers that bloom in the spring, has nothing to do with the case. If the vendor is abroad (perhaps the EN assumes this) the transfer is not a relevant transfer for the reason set out above.

Whatever one thinks of the reasoning of the EN, it does appear that the conclusions reached in this section would generally be acceptable to HMRC.

17.8 Income accruing to person abroad: causation conditions

There is not a relevant transfer merely because there has been a transfer of assets and income has become payable to a person abroad. The income must become so payable as a result of the transfer (or associated operations). The test is one of causation.

17.8.1 *Purchase of secondhand company directly*

Suppose T (UK resident) buys the shares of an already existing non-resident company ("a secondhand company"). Assume the company owns assets. That purchase involves a transfer of assets by T—the payment of the purchase price[18]—and is described in the following discussion as "the purchase price transfer".

It is the case that income accrues to a person abroad (the company). However, it cannot be said that the income became payable to the company as a result of the purchase price transfer. The company merely continues to receive the income from its own assets, as it did before, and is not in any way affected by the change in ownership of its shares. Thus if the vendor is UK resident and domiciled, the purchase price transfer is not a relevant transfer.

Now suppose T purchases the shares from a person abroad. In that case the purchase price transfer may be a relevant transfer because the vendor

18 The sale in fact involves two transfers of assets: payment of the purchase price to the vendor and transfer of the shares to T.

may invest the proceeds of sale and receive income as a result of that transfer. However, the income arising as a result of the purchase price transfer would be the income accruing to the vendor, not the company's income.

In these cases there will have been (at least) one other transfer of assets, the transfer of assets to the secondhand company (e.g. on a subscription for the company's shares). I call this "the company funds transfer". The company funds transfer is a relevant transfer. If T is the transferor of that transfer then he will in principle be within s.720 and taxed on the secondhand company's income.[19] If T is not the transferor, he may be subject to tax under s.731 if he receives benefits (unless the company funds transfer qualifies for the motive defence).

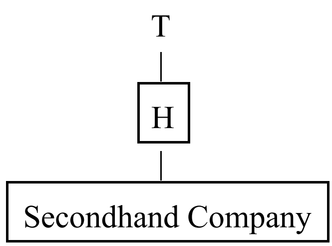
The secondhand company may later make a relevant transfer.[20] If T procures that transfer, he is its transferor.

17.8.2 *Purchase of secondhand company by holding company*

Now suppose:

(1) T transfers assets to H, an offshore company ("the H transfer").
(2) H uses its funds to purchase a secondhand company ("the purchase price transfer").

Thus the position is:



A similar analysis applies:

(1) The H transfer is in principle a relevant transfer. However, no income

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19 As to whether T is the transferor, see 18.3 (Who is the transferor?).

20 For instance, a transfer to a non-resident subsidiary. A straightforward sale of assets by the company may not be a relevant transfer because no income becomes payable. See 17.7.1 (Purchase of asset from person abroad).

arises to a person abroad as a result of that transfer.[21]

(2) The purchase price transfer is not a relevant transfer. No income accrues to a person abroad as a result of that transfer. Income does arise to the secondhand company, but not as a result of the H transfer or the purchase price transfer. However, if H provides further funds for the secondhand company, directly or indirectly, then the secondhand company will receive income as a result of the H transfer and T will be subject to tax under s.720 accordingly.

17.9 Associated operation: definition

Section 719(1) ITA provides just about the widest definition the drafter could devise:

> In this Chapter "associated operation", in relation to a transfer of assets, means an operation of any kind effected by any person in relation to—
> (a) any of the assets transferred,
> (b) any assets directly or indirectly representing[22] any of the assets transferred,
> (c) the income arising from any assets within para (a) or (b), or
> (d) any assets directly or indirectly representing the accumulations of income arising from any assets within para (a) or (b).

An associated operation does not exist in isolation, it exists in relation to a transfer. There are two requirements:

(1) It must be an "operation".
(2) It must be "effected in relation to" items (a) to (d); I describe this as

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21 Assume no income accrues to H (the secondhand company does not pay a dividend).

22 "Representing" is defined in s.717(b) ITA:

> "references to assets representing any assets, income or accumulations of income include references to—
> (i) shares in or obligations of any company to which the assets, income or accumulations are or have been transferred, or
> (ii) obligations of any other person to whom the assets, income or accumulations are or have been transferred."

Thus if (1) T transfers assets to a company and (2) T transfers the shares in the company to another person, the second transfer is an associated operation in relation to the first. This would not have been clear without the definition.

being "associated" with a transfer.

The term "associated operations" is also used in the IHTA. However, the definition is different so only limited assistance can be drawn from IHT cases.

17.9.1 *"Operation"*

"Operation" is (rightly) not defined but is clearly a word of wide import. It includes a company becoming non-resident.[23] It does not include death, but that does not matter because it does include the act of making a will.[24]

In *Herdman v IRC* 45 TC 394 there was a sale (i.e. transfer) of assets to an Irish company. The company then "accumulated" income and "managed" its assets so as to be able to repay a loan to the transferor. These were held to be "operations" by most of the judges but this is obiter and extremely difficult to accept. Unlike IHT, "operation" does not include an omission. A company does not "accumulate" income (in the legal sense). If "management" is an operation then everything is an operation (all assets must be "managed") and the expression makes no sense. Lords Pearce and Reid (more judiciously) left open the question of whether these were "operations".

17.9.2 *"Associated"*

In *Fynn v IRC* 37 TC 627:

(1) in 1948 T transferred assets to an Irish company ("the original transfer");
(2) in 1952 T lent money to the company.

The loan was not an associated operation in relation to the original transfer, because it was not effected "in relation to" the assets transferred.

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23 *Congreve v IRC* 30 TC 163.

24 *Bambridge v IRC* 36 TC 313. This case contains Harman's aphorism: "Death, as we know, is an awfully big adventure, but even the Crown admits that it is not an associated operation." This is in fact obvious, because death is not "effected by a person in relation to assets".

In *Carvill v IRC*:[25]

(1) T transferred assets to a Bermudian company (B Ltd) in exchange for shares, and so became a majority shareholder in B Ltd ("the original transfer").
(2) T became a 100% shareholder in B Ltd by (a) purchasing shares and (b) B Ltd purchasing its own shares.
(3) B Ltd entered into arrangements to remunerate T via a personal services company and a brokerage sharing agreement.

Steps (2) and (3) were not operations associated with the original transfer: they did not relate to the assets transferred.

17.9.3 *Associated operation preceding the transfer*

Section 719(2) ITA provides:

> It does not matter whether the operation is effected before, after, or at the same time as the transfer.

This provision (introduced in 2006) gives statutory effect to the view formerly expressed in RI 201.[26] I cannot think of a practical case where it would matter and would be grateful to any reader who could explain why HMRC thought this point was worth legislating for.

17.9.4 *Is mere historical association enough?*

On a simply reading of the definition, an operation can be "associated" with an earlier transfer even if the two were not part of any plan and many years apart. Suppose:

(1) A transfers an asset to B (who is UK resident) in 1970; and

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25 [2000] STC (SCD) 143 at [80]-[85], 75 TC 477 (Special Commissioners).

26 "The wording of s.742(1) ICTA is interpreted as meaning that an associated operation does not necessarily have to take place after a transfer of assets. A transaction undertaken "in relation to" a transfer of assets can precede the transfer."

That seemed right. The FA 2006 gave no thought to transitional provisions but in the circumstances it does not matter.

(2) B transfers the asset in the year 2000 to an offshore trust under which A may benefit.

On a simple reading, B's disposition is an associated operation in relation to A's transfer even though:

(1) they are not part of a single arrangement;
(2) A is unaware of B's disposition;
(3) B's disposition is itself a relevant transfer;
(4) one or both transfers is a sale on arm's length terms.

The same would apply if A's transfer was made in 1870 or 1670. Indeed, anyone who purchases or disposes of an estate in English land is only effecting the most recent "operation" of a series of associated operations (dispositions of the land) which may perhaps be traced back to the Norman Conquest if not before, and only a lack of records prevents one tracing the sequence of associated operations to the dawn of civilisation. In fact this simple reading cannot be right, for reasons given below.

17.10 Significance of associated operations

It is never enough to establish that there is an associated operation in relation to a transfer. This is just the first step. One must then go on to ask what (if anything) follows. The term "associated operations" is used in the definition of "relevant transfer"[27] and it is used in the definition of "relevant transaction"; s.715(1) ITA provides:

> A transaction is a relevant transaction for the purposes of this Chapter if it is—
> (a) a relevant transfer, or
> (b) an associated operation.

The existence of associated operations is therefore relevant to the following:

(1) *Section 716 ITA*: Income becomes payable to person abroad as a result

27 See 17.2 ("Relevant transfer").

of transfer and/or associated operations.[28]

(2) *Section 721 ITA*: Individual has "power to enjoy" as a result of transfer and/or associated operations.[29]

(3) *Section 729 ITA*: Individual receives capital sum connected with any relevant transaction.

(4) *Section 732 ITA*: Individual receives a benefit as a result of the transfer or associated operations.[30]

(5) *Section 733 ITA*: "Relevant income" is income which can as a result of the transfer or associated operations be used for providing a benefit.[31]

(6) *Motive defence*: All relevant transactions must satisfy the conditions of the motive defence.[32]

17.11 Person abroad receives income as indirect consequence of transfer

17.11.1 *Transfer from A to B followed by transfer from B to person abroad*

Suppose:

(1) in 1970 A transfers an asset to B (who is a UK resident individual) ("A's transfer"); and

(2) in 2000 B transfers the asset to an offshore trust ("B's trust") under which A may benefit ("B's transfer").

(3) A's transfer and B's transfer are not part of a single arrangement and A is unaware of B's transfer.

B's transfer is obviously a relevant transfer. The question is whether A's transfer is a relevant transfer.

It may be helpful to recap the definition. Section 716(1) ITA provides:

> A transfer is a relevant transfer for the purposes of this Chapter if—

28 See 17.11 (Person abroad receives income as indirect consequence of transfer).

29 See 15.9 (Avoiding the s.648 clawback); also power to enjoy, Condition C.

30 See 19.6 (Benefit causation condition).

31 See 18.29 (Is income of company relevant income?).

32 See 21.39 (Associated operations and motive defence before 5 December 2005) and 21.40 (Transfer and associated operations both after 4 December 2005).

(a) it is a transfer of assets, and
(b) as a result of—
(i) the transfer,
(ii) one or more associated operations, or
(iii) the transfer and one or more associated operations,
income becomes payable to a person abroad.

A's transfer meets condition (a): it is a transfer of assets. Income becomes payable to a person abroad. Causation condition (i) is not satisfied, that is, it is not as a result of A's transfer alone that income has become payable to the offshore trustees. However, B's transfer is at first sight an "associated operation" in relation to A's transfer. It seems at first sight that causation condition (ii) is satisfied: income becomes payable to the trustees as a result of the associated operation (B's transfer); so A's transfer is a "relevant transfer" and A is taxable under s.720 on the income of B's trust! This clearly cannot be right; but why not? The motive defence is not a satisfactory solution to this problem:[33] one must conclude that A's transfer is not a relevant transfer, that is, it does not satisfy causation condition (ii). How do we reach this result?

17.11.2 *Position before 2007/08*

Before 2007/08 the TAA provisions applied a more limited causation test. They only applied to:

> transfer of assets *by virtue or in consequence* of which, either alone or in conjunction with associated operations, income becomes payable to persons resident or domiciled outside the UK.

This applied causation condition (i) and (iii) but not causation condition (ii).

In the 5th edition of this book I said:[34]

> One might reach this result by understanding [restricting] the reference

33 The motive defence could not help if either A's transfer or B's transfer was made for tax avoidance reasons; or even if B's transfer was innocent but A was unable to prove this: see 21.39 (Associated operations and motive defence before 5 December 2005).

34 5th edition, para 14.11. Footnotes omitted.

> to "associated operations" to mean only those forming part of a single arrangement. However, it is suggested that a better analysis, the key to making sense of "associated operations" everywhere in the transfer of asset provisions, rests on the concept of causation. In the example above, although income accrues to the offshore trustees, it does not do so "in consequence" of A's transfer *in conjunction* with B's transfer. The only cause is B's transfer.
> But for A's transfer, B's transfer would not have happened, and so income would not become payable to the person abroad. However, causation in law (and indeed in ordinary English usage) does not apply a simple "but for" test. B's transfer as an independent act will "break the chain of causation". That is, the reference to words of causation requires one to identify the real or effective or operative cause of the fact that income accrues to a person abroad (which in this case is B's transfer). There must be "sufficient causal connection."

So I concluded:

> Although the statutory words are different, it is suggested that the appropriate test is the "clean break" test, i.e. is A a settlor of B's trust, did A provide the property indirectly?

17.11.3 *Position from 2007/08*

Unfortunately the key which allowed the reader to make sense of the provisions has been discarded in the tax law rewrite.[35] I infer that HMRC found causation an inconvenience, so they quietly[36] but substantially relaxed it, by adding causation condition (ii). But no consideration was given to the consequences. The removal of foundations, however inconvenient, has an effect on the structure as a whole. The result is a gap which the courts will have to fill up as best they can. It continues to be the case, in the example above, that A *cannot* be the transferor and within s.720. But on what grounds can one reach that result? Something must be read into the statutory wording.

One solution is to say that there can only be one transferor; since B is

35 The rewrite team would probably say that s.742(1A) ICTA (introduced in 2006) made this change. That was arguably not the correct view of that provision, but it does not now matter.

36 The EN did not mention this important change.

clearly a transferor, A is not to be regarded as transferor. This has some support in *Vestey*.

The best solution, now the key to understanding associated operation rules throughout the TAA provisions, is to say that operations cannot be "associated" unless they are "put in train" by one person. Mere historic association is not enough to constitute "associated operations" for the purposes of the Act. There must be something more.[37] In an ideal world, Parliament should have identified that "something more" and not leave the job of constructing workable legislation to the courts. But there it is. It is suggested that the test for associated operations is the "clean break" test, i.e. is A a settlor of B's trust, did A provide the property indirectly?[38] If not, the operations are not associated.

17.11.4 *Transfer to UK trust followed by migration of trust before 6 April 2006*

Suppose:

(1) In 1970, A transfers assets to a discretionary trust with UK trustees ("A's transfer");
(2) In 2000, the UK trustees appoint foreign trustees in their place and transfer the trust assets to them ("the appointment of foreign trustees").

The appointment of foreign trustees is a relevant transfer. (The appointment of foreign trustees involves a transfer of assets, as a result of which income accrues to the non-resident trustees.) The question is whether A's transfer does likewise. That is, is it a relevant transfer?

A's transfer alone does not satisfy causation condition (i). Income becomes payable to a person abroad. But causation condition (i) is not satisfied because it is not as a result of A's transfer alone that income has become payable to the offshore trustees. However, the appointment of

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37 Contrast the approach to "disposition by associated operations" in *IRC v Brandenburg* [1982] STC 555, where Special Commissioners added a gloss that a disposition made by associated operations (for IHT purposes) must be "put in train" by one person: see "Gifts by Associated Operations", Robert Venables QC, PTPR, Vol. 5, p.11.

38 See 58.4 (Gift from A to B followed by gift to trust by B).

foreign trustees is an "associated operation" in relation to A's transfer. Before the ITA 2007, the question was whether A's transfer in conjunction with the associated operation together satisfied the causation condition. It is considered that it was as a result of the transfer in conjunction with the associated operation that the income accrued to the foreign trustees. This was so even if the appointment was not envisaged at the time of the transfer to the original settlement. With the current wording, the literal reading is that A's transfer is a "relevant transfer". This is simply because the appointment of foreign trustees is an associated operation, and income becomes payable to a person abroad as a result of that operation; causation condition (ii) is satisfied. Although some gloss is required to make the section work, in other cases, as discussed above, that gloss is not likely to alter the result in this case.[39]

17.11.5 *Transfer to trust followed by transfer from trust to offshore company*

This is in principle the same as 17.11.4 (Transfer to UK trust followed by migration of trust before 6 April 2006). This applies whether the transfer by the trustees is gratuitous or in exchange for shares, debentures or an offshore life policy. But if the investment is for wholly commercial reasons, it may be argued that is not the case and so the income of the underlying company is not within the TAA provisions, but this requires the Courts to read words into the statute, and the case for doing so here is not strong enough.

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39 The position in 17.11.1 (Transfer from A to B followed by transfer from B to person abroad) is different. There B's transfer is independent in a way that trustees are not, because trustees are constrained by the fiduciary nature of their powers.
This view is also supported by obiter dicta in *Congreve v IRC* 30 TC. This concerned a gift to a UK company which became non-resident. This was a relevant transfer without the association operations rule. See 17.5 (Income "becomes payable" to person abroad). But the House of Lords also held (at 206) that the company becoming non-resident was an associated operation; and (by inference) income arose to the company abroad as a result of the transfer and associated operation.
HMRC would have further arguments, if necessary, based on *Muir v Muir* [1943] AC 468.

17.11.6 *Transfer to company followed by migration of company*

This is a relevant transfer even without the associated operations rules.[40]

17.11.7 *Transfer to UK trust followed by migration of trust from 6 April 2006*

Suppose the facts of 17.11.4 (Transfer to UK trust followed by migration of trust before 6 April 2006), but assume the migration occurred after 6 April 2006. The trust is deemed to be a single person. The analysis is therefore different. The appointment of foreign trustees does not involve any transfer. Instead the analysis is the same as 17.11.6 (Transfer to company followed by migration of company). The end result is the same, though the route to that destination is different.

17.12 Income of person abroad

The concept of "income of the person abroad" is relevant for several purposes of the transfer of asset provisions:

(1) There is a relevant transfer only if "income becomes payable" to a person abroad. If *no* such income becomes payable then there is no relevant transfer and the TAA provisions cannot come into effect.
(2) The *identity* of the income payable to the person abroad as a result of the transfer is relevant:
   (a) for s.720 ITA, as one must ask whether the transferor has power to enjoy that income;
   (b) for s.731 ITA, as one must ask whether that income can be used to benefit an individual.
(3) The *amount* of income payable to the person abroad as a result of the transfer is relevant as ascertaining that amount is the first step in computing the amount on which tax is charged under s.720 or relevant income for s.731.

17.13 Capital receipts deemed to be income

The transfer of asset rules refer to "income". This means "income for

40 See above footnote.

income tax purposes" which is a different concept from "income for trust law purposes" or "income for accountancy law purposes".[41]

Section 383 ITTOIA provides:

> (1) Income tax is charged on dividends and other distributions of a UK resident company.
> (2) For income tax purposes such dividends and other distributions are to be treated as income.
> (3) For the purposes of subsection (2), it does not matter that those dividends and other distributions are capital apart from that subsection.

This applies for the purposes of the TAA provisions and s.624 ITTOIA, so the distribution on a purchase of own shares, for instance, is income for those purposes[42] even though it is a capital receipt for trust law purposes. Likewise income deemed to accrue on a stock dividend under s.249 ICTA and a gain deemed to be income under s.688 ITA (transactions in land). On gains from offshore funds: see 23.14 (OIG accruing to non-resident trust). On gains from life policies see 22.6.1 (Non-resident trusts) and 22.6.2 (Non-resident company or institution).

17.14 The amount of income of person abroad

This section considers the amount of the income arising to the person abroad as a result of the transfer and associated operations.

17.14.1 *Dividend income of person abroad: net or gross?*

In order to follow the discussion one needs to bear in mind the usual rules for taxing a UK dividend.[43]

Section 398(1) ITTOIA provides for grossing up a UK dividend by the amount of the tax credit:

> If a person is entitled to a tax credit in respect of a dividend or other distribution, the amount or value of the dividend or other distribution is treated as increased by the amount of the tax credit for all income tax

41 See 11.2 (Why does "capital *v.* income" matter?)

42 This is assumed to be the case in the drafting of s.482 ITA.

43 References in this section to dividends also include other company distributions.

purposes (except section 397(1)).

A non-resident does not usually qualify for a tax credit. This allowed one taxpayer to argue that the measure of income for s.720 ITA is the net dividend only. The argument was rightly rejected:

> 100. [HMRC] contended that the income which the section deems to be income of the taxpayer is the dividends. ...
> It follows [from what is now s.746 ITA] that the position is the same as if the taxpayer had actually received those dividends. They would be grossed-up by the amount of the tax credit and he would be entitled to the benefit of the tax credit. The position is just as if International Holdings [the person abroad] had never existed.
> 101. [The taxpayer] contended that the income which was deemed to be the taxpayer's was the net income of the company from all sources after deduction of any reliefs which would have been available to an individual in a comparable position. The income lost its original characteristics and became charged under Case VI of Sch D. ...The effect of this approach is that because [the person abroad who received the dividend] is not entitled to the tax credit, the income is not grossed up but is not charged to income tax at the lower rate [now the dividend ordinary rate].
> 102. It is not necessary for me to decide this point but I find [HMRC's] approach more attractive particularly as it precisely gives effect to counteracting the advantage of the transfer.[44]

For s.731 purposes, the amount of a dividend would, strictly, be the gross amount. However, the tax credit is not income which can be applied for the benefit of any person so the amount of relevant income is the net amount without the tax credit.

17.14.2 *Deduction of administration costs against investment income*

In *Chetwode v IRC* 51 TC 647 an offshore company received dividends and interest of about £3,000 per annum. The transferor was taxed on the gross amount of that income, without deduction for (i) investment advisory fees, (ii) management fees, (iii) safekeeping charges, (iv) security handling fees and bank charges, (v) registered office and executive office

44 *Carvill v IRC* [2000] STC (SCD) 143, 75 TC 477.

fees, totalling about £1,000 per annum. The approach of *Chetwode* was that s.720 should be construed so as to put the transferor in the same position as if he had retained the assets himself. Had he done so he could not have deducted these investment costs for the purposes of calculating his income. So there was no deduction for s.720 purposes.

HMRC allowed deductions in respect of estimates of such costs of collecting the investment income as would have been incurred had the investment income been instead received by the transferor in person. This was calculated (how?) at about £20 per year. There is no statement on whether this concessionary practice still obtains but it is (perhaps) worth claiming it to see.

For s.731 purposes such expenses will be deducted in computing relevant income.

17.14.3 *Trading income and trading losses of person abroad*

It was accepted in *Chetwode* that trading income of the person abroad is calculated by setting trading receipts against trading expenses. The case does not discuss whether trading income is calculated:

(1) by accountancy principles, under which statutory non-deduction provisions such as s.34 or s.45 ITTOIA would not apply, and depreciation would in principle be allowed; or
(2) by tax principles applicable to calculating trading profits.

The approach of *Chetwode* suggests that the second is the correct view. For losses, RI 201 provides:

> The Revenue's practice is only to allow trading losses to be carried forward and set against future trading profits. They cannot be offset against investment income of the same, previous or future years.

This is consistent with the position for property income losses. For s.731, losses will be deducted in computing relevant income if paid out of relevant income. There is no group relief.

17.14.4 *Property income of person abroad*

The rules for measuring property income are the same as for the settlement provisions; see 16.2.4 (Computation of property income of trustees). Transfer pricing may also need consideration here.

17.14.5 *Loan relationship and Forex income*

Since income is computed on IT principles, "income" does not include profits computed under loan relationship or Forex rules which apply for the purposes of corporation tax and not for IT purposes. This is so even if the person abroad is a company.

17.15 Disclosure of TAA issues in tax return[45]

Question 5 of the 2007/08 self assessment return provides:

> Have you, or could you have, received (in the widest sense) income, or received a capital payment or benefit, from a person abroad as a result of any transfer of assets?

This wording (or something similar) has been used since 1999, probably as a result of John Avery Jones' harsh criticism of the earlier wording.[46] Unfortunately this question is even less aptly worded than its predecessor. Since offshore trusts generally have power to add beneficiaries, they can benefit everyone in the world. So if the question is taken literally, everyone should tick the yes box. Since that cannot be the intention, it is suggested that the sentence must be construed to be asking this question:

> Have you, or could you have, received ... income, or received a capital payment or benefit, from a person abroad as a result of any transfer of assets *in circumstances in which section 720 or s.731 apply to you*?

If that is the right construction, then it is not necessary to tick the box in circumstances where the sections do not apply, for instance because the individual is not ordinarily resident; but the more cautious taxpayer may wish to tick the box to avoid any possibility of criticism if (1) he is a

45 See also 21.45 (Motive defence claim in tax return).

46 "It occurred to me to wonder whether Parliament had really authorised the asking of a [*word deleted—ed.*] question": see [1998] BTR 392. It was suggested in the fourth edition of this book at para 12.7.2 that the old wording was not quite as wide as Avery Jones suggested. However, this question does not now arise.

transferor or (2) he has received benefits.

CHAPTER EIGHTEEN

TRANSFER OF ASSETS ABROAD: TRANSFERORS

18.1 The charge to tax

This chapter considers the TAA charges on the transferor. There are strictly two charges: s.720 and s.727 ITA, but s.720 is by far the most important.

Section 720 ITA imposes the charge to tax:

> **720 Charge to tax on income treated as arising under section 721**
> (1) The charge under this section applies for the purpose of preventing the avoiding of liability to income tax by individuals who are ordinarily UK resident by means of relevant transfers.
> (2) Income tax is charged on income treated as arising to such an individual under section 721 (individuals with power to enjoy income as a result of relevant transactions).
> (3) Tax is charged under this section on the amount of income treated as arising in the tax year.

For the rates of tax, see 34.6 (Rates of tax on transferor within s.720 ITA). For a comparison with s.624 ITTOIA see 16.15 (Section 624 ITTOIA *v* s.720 ITA: comparison and priority).

18.2 Who is liable?

Section 720(5) ITA provides:

> The person liable for any tax charged under this section is the individual to whom the income is treated as arising.

ITA EN provides:

> 2141. Subsection (5) provides that the individual to whom income is treated as arising is the person liable. This person is defined in section 721.

So we turn to s.721 ITA but we do not find a definition:

> **721 Individuals with power to enjoy income as a result of relevant transactions**
> (1) Income is treated as arising to such an individual as is mentioned in section 720(1) in a tax year for income tax purposes if conditions A and B are met.

The charge is imposed on "such an individual as is mentioned in s.720". There are different views possible of how much of s.720(1) is incorporated into the requirement that the individual to be taxed must be "such an individual as is mentioned in s.720". The wise words of Garner are worth quoting here:

> *Such* is a deictic (pointing) term that must refer to a clear antecedent.[1]

The drafter's failure to observe Garner's point – obvious though it may seem – has given rise to a good deal of case law. The intention of the ITA rewrite was to preserve the case law and (so far as the law was unclear) to preserve the ambiguities. ITA EN provides:

> 2144. Sections 739(2) and (3) of ICTA indicate the person liable by using the expression "such an individual" – but do not make it clear how much of section 739(1) is implied by that expression. [Sections 721] and 728 ITA, which are based on section 739(2) and (3) ICTA, reproduce the expression "such an individual", which has been the subject of case

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1 *A Dictionary of Modern Legal Usage*, 2nd edition, entry under "Such". Harold Pinter adroitly exploits the ambiguity in *No Man's Land*:

> "... there are some people who appear to be strong, whose idea of what strength consists of is persuasive, but who inhabit the idea and not the fact. What they possess is not strength but expertise. They have nurtured and maintain what is in fact a calculated posture. Half the time it works. It takes a man of intelligence and perception to stick a needle through that posture and discern the essential flabbiness of the stance. I am *such a man*."

law: see, in particular, *Vestey v IRC* 54 TC 503.

What, then, is the reference implied by the expression "such an individual"? On any view, it refers only to an individual ordinarily resident in the UK.

Further, it was decided in *Vestey* that s.720 applies to one specific individual, "the transferor". In this book I use the term "transferor" to mean the person to whom s.720 applies.

18.3 Who is the transferor?

The next question is to identify the transferor (if there is one). Clearly, anyone who actually makes a transfer is a transferor, but the expression is a little wider than this.

18.3.1 *Transfer made by individuals jointly*

If A and B together own an asset, as tenants in common or as joint tenants, and together transfer their interest to a person abroad, each is transferor of his share. RI 201 states:

> Where the same assets are transferred by several individuals, the Revenue's practice is to assess the transferors in proportion to their share of the assets transferred. Thus, where, for example, shares of a UK company are held by three shareholders in the proportion 40%, 40% and 20% and there is [s.720 ITA] liability in respect of the income of an overseas person to which the shares are transferred, the liability is assessed on each of the three shareholders in proportion to their respective holdings.

That seems obvious.

18.3.2 *Transfer procured by individual*

In *Congreve v IRC* the Court of Appeal said in an obiter comment:

> But even if we were prepared to accede to the argument that the preamble [now s.720(1) ITA] connoted activity by the individual concerned, we think this condition would be fulfilled if the execution of the transfer were procured by the individual concerned, even though it

> was not actually executed by him or his agent. [Counsel] said ... that execution by a company could not be said to be execution by the individual, even though the individual owned all or practically all the shares in the company. We think, however, that the decision of the learned Judge can be upheld on the ground we have stated, since it is, we think, in the present case, a reasonable inference from the facts found that the execution and performance of the transfers and associated operations in question by all the companies concerned were procured by Mrs. Congreve acting through her agent.[2]

In *Vestey v IRC*, the question of who is a transferor did not arise, because the taxpayers (merely beneficiaries of a discretionary trust) were clearly not transferors. The House of Lords discussed the question in passing, and the answer was expressed in a variety of different ways. Lord Wilberforce said s.720 applies:

> only where the person sought to be charged made or, maybe, was associated with, the transfer.[3]

Lord Keith said the section only applied to an individual:

> who has sought to avoid liability to income tax by means of such transfers of assets as are mentioned in [s.720(1)].[4]

Lord Dilhorne said the section applied to an individual:

> who has sought to avoid income tax[5]

though in the same paragraph he also approved the Court of Appeal's comment in *Congreve* (which one might have thought a somewhat different approach).

Likewise Lord Edmund-Davis:

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2 30 TC 163 at p.197.

3 54 TC 503 at p.587. Lord Salmon agreed. Lord Keith said he agreed with Lord Wilberforce but in his concurring speech he actually put the matter differently.

4 p.602G.

5 p.591E.

> individuals whose purpose is the avoidance of liability to tax ...[6]

Thus in *Vestey*, the question who is a transferor had received three different answers (though in practice the differences may not often matter).

These doubts were resolved in *IRC v Pratt* which decided that a person who did not make the transfer may be within s.720 if and only if he "procured" the transfer.[7] The term used in *Pratt* is "quasi transferor" but I suggest it is better to use the term "transferor" and to define that term to mean those who make a transfer and those who procure it.

The classic example is if T owns all the shares in a company and he uses his power of control to procure the company to make a transfer to a person abroad.

> Something of the sort might even be possible in the case of quasi transferors, where two or three of them own the company which makes the transfer, but where it is not possible to do just that, s [720] does not bite at all. ... Where an identifiable portion of the asset transferred can be attributed to a particular transferor then, of course – at any rate in any normal case – that part actually transferred will produce a similar part of the income, and in no case is there any difficulty in applying the section, since one will apply it separately to each of the individual transfers, or each identifiable portion.[8]

Walton J expresses himself tentatively, but this is thought to be the law. The position would be different if shareholders had different classes of shares with different interests. In that case it may not be possible to separate out their interests and the shareholders would not be transferors.

The facts of *Pratt* were that the taxpayers (i) were three directors out of eight; and (ii) held 30% of the company. They had no control at director or shareholder level. They could not "procure" the transfer of assets made by the company, and so they were not "quasi transferors" in relation to that transfer. So they were outside the scope of s.720. Of course a person who is not a transferor (such as the successful appellants in *Pratt*) might fall within s.731 if he received benefits.

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6 p.601B.

7 57 TC 1 at p.51 B –D and p.55 E–F.

8 *IRC v Pratt* 57 TC 1 at p.50.

In *Carvill v IRC*, T transferred the majority shareholding to a person abroad, and the minority shareholders transferred their shares. HMRC argued (implausibly) that T was the "transferor" of the minority shareholding. But this was rightly rejected:

> For an individual to be the transferor in relation to a transfer by another individual would be a considerable extension of this principle. However, there might be cases where, as a matter of fact, one individual's influence over another was so strong that he was the transferor of the other's share but this would clearly be an exceptional case. ...
>
> 72. [Counsel] contends that the taxpayer was the transferor of the old minority shares. In order to find that this was an exceptional case where the taxpayer did in effect force his will on the other shareholders so as to become the transferor of their shares, one would need strong evidence that this was so. Of course, the taxpayer as majority shareholder and one of the founders of a company bearing his name was in a position of some influence. However, the influence did not go as far as telling other shareholders what to do with their shares. Here the decision by the old minority to transfer their shares was one which they came to after discussion, having started with different points of view as to the merits of the transfer. There is no evidence that the taxpayer leaned on any of them heavily, for example, by threatening to sack them if they did not. ... Accordingly, there is no evidence that the taxpayer did anything in relation to the old minority shares which would make him the transferor of them, and I find that he was not the transferor of the old minority shares.[9]

What about a gratuitous transfer from A to B and from B to the person abroad? The question whether A has procured B's transfer does not arise, for A is a transferor by virtue of the transfer to B. The true question is whether B's transfer is caught under the associated operations rules.

What if A (perhaps a principal beneficiary but not settlor) encourages trustees to make a transfer? It is suggested that A (not being in control of the trust) cannot be said to procure the transfer made by the trustees. Likewise a trustee or other person exercising fiduciary powers is not a transferor, e.g. a person with power of appointing new trustees does not

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9 *Carvill v IRC* [2000] STC (SCD) 1543 at [71]-[72], 75 TC 477 (Special Commissioners).

become a transferor if he exercises the power because the power is fiduciary. So the concept of "procuring" a transfer in practice applies to individuals controlling companies; other cases, while theoretically possible, will be rare.

Contrast the position where:

(1) T transfers assets to A in consideration for which A transfers assets to a person abroad.
(2) T transfers assets to a company in consideration for which the company issues shares to a person abroad.
(3) T (an employee entitled to a bonus) waives his entitlement in consideration for which the employer transfers assets to a pension scheme abroad.

In the first two cases, T is not just a quasi transferor, he is an *actual* transferor for he has made a transfer of assets. In the third case, T has procured the transfer so he is within the scope of s.720.

18.3.3 *HMRC practice*

RI 201 provides:

> [1] Section [720 and 727 ITA] can potentially apply not only to an individual who transfers assets but to someone who is "associated with" a transaction (according to the decision of the Courts in *Vestey v IRC*).
> [2] The Revenue regard this as including anyone who procured the transfer of assets.

Point [1] quotes one of the views tentatively expressed in *Vestey*[10] but disingenuously omits the "maybe". If "associated" here has its normal, rather loose and wide sense, point [1] is clearly wrong in the light of *Pratt* and *Carvill*. It is suggested that a person is a transferor only if he has made or procured the transfer, and being associated with a transfer (without procuring it) does not make a person a transferor. In a loose sense of "associated" point [1] cannot possibly be correct, for many

10 The comment of Lord Wilberforce is set out at 18.3.2 (Transfer procured by individual).

individuals may be "associated" with a transfer who cannot possibly all be transferors.

Point [2] is correctly based on *Pratt*. However, in practice HMRC do not take the s.720 point when UK companies (not established for s.720 avoidance) make transfers abroad, even if there is a 100% shareholder who could be assessed as procuring the transfer. (There is no significant reference to the TAA provisions in *Bramwell on Corporation Tax* and none in the Company Taxation Manual.) Perhaps the CFC legislation is intended to fill the gap.[11]

18.4 Must the transferor avoid or intend to avoid IT?

18.4.1 *The statutory provisions*

Section 720 ITA provides:

> (1) The charge under this section applies for the purpose of preventing the avoiding of liability to income tax by individuals who are ordinarily UK resident by means of relevant transfers.
> (2) Income tax is charged on income treated as arising to *such an individual* under section 721 ....

The Special Commissioners say:

> 185. It is clear that the meaning of the phrase "such an individual" must be found in the preamble [now s.720(1)] and that it is not confined to an individual "ordinarily resident in the United Kingdom". Once you go beyond that restricted meaning in order to ascertain what individuals are comprised in the phrase "such an individual" it seems to us difficult to find any logical stopping place short of importing the whole of [s.720(1)].
> 186. In our view it therefore follows that "such an individual" is an individual ordinarily resident in the United Kingdom who, *by means of a transfer* of assets in consequence of which income becomes payable to a non-resident, *avoids liability to income tax apart from the operation*

11 It is noteworthy that the CFC legislation followed shortly after *Pratt*. Though s.725 ITA (reduction in amount charged when CFC involved) acknowledges possible overlap between the CFC rules and s.720.

of these provisions.[12]

This is, with respect, clearly right. The question which arises is whether a person who "by means of transfers of assets avoids liability to income tax" means:

(1) a person who in fact avoids income tax (in the absence of the TAA provisions); or
(2) a person who in fact avoids and intends to avoid IT; or
(3) a person who intends to avoid IT (whether or not he in fact does so).

I am inclined to think that solution (1) is the most natural reading, as the word "avoids" suggests avoidance in fact. However the words "by means of" might be thought of as involving some element of intention, so there is also much to be said for solution (2), i.e. s.720 only applies to a person who in fact avoids and intends to avoid income tax, (though this does overlap with the motive defence.)

18.4.2 *Position before 1996*

In order to understand the present law, it is necessary first to consider the position before the law was changed in 1996. Case law and statutory reform have complicated what ought to be a simple question with a simple answer.

The starting point is the decision of the House of Lords in *McGuckian v IRC.*[13] This was (in short) a case where a transaction was made which was intended to avoid income tax but did not actually do so (because another anti-avoidance provision was overlooked.)[14] The Revenue raised an

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12 *IRC v Botnar* 72 TC 205.

13 69 TC 1.

14 The actual facts were not so simple. An interest in possession trust owned a company, and a dividend would have been taxable income of the life tenant. Instead the trustees sold the right to the dividend for a lump sum. This sum was trust capital as a matter of trust law (though it was regarded as income for tax purposes under the *Ramsay* principle. This sale was intended to avoid income tax on the dividend.
It was assumed that the transaction did not actually avoid IT, since the sale of a dividend is caught by anti avoidance provisions (s.730 ICTA 1988). Is this right? One might have argued that income tax *was* in fact avoided since even though it

assessment under s.720. The taxpayer argued that s.720 did not apply since income tax was not actually avoided. The argument failed. Lord Steyn said:

> I would reject the argument that it is a condition precedent to [s.720] applying that there must be proof of an actual avoidance of tax liability. Such a construction treats [s.720] as a power of last resort and it substantially emasculates the effectiveness of the power under [s.720]. Nothing in the language or purpose of [s.720] compels such a construction. Properly construed the opening words of [s.720] merely provide that *there must be an intention to avoid liability for tax*. The sensible construction is that [s.720] can be applied even if there are other provisions which could be invoked to prevent the avoidance of tax. That the revenue authorities should have overlapping taxation powers is an unremarkable consequence. And such a construction cannot cause any unfairness to the taxpayer since he cannot be taxed twice in respect of the same income.[15]

Lord Browne-Wilkinson said:

> [Counsel for the taxpayer] submitted that since the dividend would in any event have been taxable under s 470, [s.720] does not apply. He based this submission on the words in [s.720(1)],
>
> > "For the purpose of preventing the avoiding by individuals ordinarily resident in the United Kingdom of liability to income tax …".
>
> He submitted that [s.720] does not apply unless tax has *in fact* been avoided. In my judgment, there is no warrant for this submission. ... the words of subs (1) make it clear that the actual avoidance of tax is not a precondition to the application of the section. The income is deemed to be the income of the United Kingdom resident
>
> > "whether it would or would not have been chargeable to income tax apart from the provisions of this section".
>
> It is therefore clear [!] that [s.720] can still apply even though the effect of the transfer of assets abroad would not have been successful in

was assessable under s.730, no assessment was actually made, but the Revenue did not argue that point. The taxpayer was however assessed under (what is now) s.720 ITA rather than s.730. The simple answer to this should have been to raise the assessment under s.730, as the Court of Appeal decided, but HL did not pursue that approach.

15 69 TC 1 at p.82E.

avoiding United Kingdom income tax.[16]

It is an understatement to say that the reasoning is not compelling,[17] but the decision is still binding. The position before 1996 was settled. The majority of the House of Lords[18] decided that it was not a requirement of s.720 that income tax had to be avoided, though Lord Steyn said that there did have to be an *intention* to avoid income tax.[19]

Thus the law until 1996 was that:

(1) section 720 only applied to a person who intended to avoid income tax; but
(2) actual avoidance of income tax was not necessary.

18.4.3 *Position from 1996*

Section 721(5) ITA provides:

> It does not matter for the purposes of this section ...
> (c) whether the avoiding of liability to income tax is a purpose for which

16 69 TC 1 at p.76.

17 The reason given by Lord Steyn is not compelling since s.720 is not a "power". The reason given by Lord Browne-Wilkinson is not compelling, since the words he cites (now s.721(5)(a) ITA) are needed for where a transfer reduces the rate of income tax (without avoiding it completely.) It is significant that neither judge cites the reason given by the other.
Unfortunately, it was impossible to have any sympathy with the taxpayer or his advisors, whose actions ("disingenuous in the extreme") were held to be the reason why no assessment was made under the correct section in the first place and whose appeal had "no ethical merit". One suspects that this was a case where the decision was made first and the reasons were found later. The issue was first raised in the House of Lords (it is not mentioned in the lower judgments) and so the Lords did not have the benefit of the consideration of the lower courts on the issue.

18 Lord Lloyd agreed with the other judgments; the other two judges did not consider the point.

19 This area was considered in a thorough Special Commissioners decision just before *McGuckian*: *Botnar v IRC* [1998] STC 38 at pp.63–67. Here the *Revenue* submitted (and the SCs accepted) that s.720 only applies if there is avoidance of IT *in fact*. See para 180. But this has now been overtaken by *McGuckian*. The Special Commissioners also inclined to the view that s.720 only applied if the transferor intended to avoid Income Tax. Had *McGuckian* been decided first, they would no doubt have cited and followed the comment of Lord Steyn set out above. But this has now been overtaken by the statutory reform.

the transfer is effected.

This applies to income arising on or after 26 November 1996 regardless of the date of the transfer. This does not affect the operation of the motive defence but it reverses point (1): s.720 applies even it there is no purpose of avoiding income tax.

The provision does not expressly deal with point (2) - actual avoidance. It is suggested that the consequence of this amendment is that the question of whether there must *in fact* be an avoidance of income tax needs to be revisited. For Parliament retained the statutory words set out in 18.4.1 (The statutory provisions) which refer to avoiding income tax. The words should be taken to mean something. If they no longer refer (as Lord Steyn thought they did) to the intention to avoid income tax, they should be taken to require that income tax is *in fact* avoided.[20] Thus it is tentatively suggested that the effect of s.721(5) is to reverse the decision of *McGuckian* on this issue.

The position for income arising from 1996 is therefore that:

(1) an intention to avoid income tax is not a requirement for s.720 to apply.
(2) income tax must in fact be avoided for the section to apply.

This raises the question of what amounts to the avoidance of income tax

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20 This is consistent with the view that HMRC take of s.752(1) ITA (transactions in land) which provides: "This Chapter has effect for the purpose of preventing the avoidance of income tax by persons concerned with land or the development of land." BIM provides:

> **60315. Conditions: Avoidance**
> Section 776 ICTA 1988 is anti-avoidance legislation (Section 776(1) ICTA 1988). The test for avoidance is an objective one, i.e. has tax been avoided, and not a subjective one relating to the intentions of the participants.
> The avoidance need not, therefore, be deliberate, it can be accidental or unwitting ...
> **60320. Conditions: Avoidance: Straightforward transactions of purchase and sale**
> Section 776 ICTA 1988 cannot be used to catch straightforward transactions of purchase and sale of land that do not amount to a trade, or adventure in the nature of trade....
> Section 776 ICTA 1988 is not applicable because the necessary avoidance of tax is not present.

in fact. If the taxpayer avoids an assessment (especially by dubious means) then it is suggested that income tax is avoided. Thus the assessment in *McGuckian* would still be upheld under s.720, though for slightly different reasons.

18.5 Transferor not ordinarily resident

Section 720 refers to an individual who is ordinarily resident in the UK, but it does not say exactly when the individual must be ordinarily resident for the section to apply.

18.5.1 *Transferor not ordinarily resident when income arises*

Section 720 does not apply to income which arises while the transferor is not ordinarily resident in the UK.[21]

A non-resident individual is subject to tax at his personal rates on his UK rental income. That individual can transfer UK land to an offshore company in order to avoid higher rate income tax.[22] (It is not usually necessary for the individual to transfer other assets to a company in order to avoid higher rate tax as income of a non-resident from most other sources is not subject to tax at the higher rate: s.744 ITA.)

A UK resident but not ordinarily resident individual is subject to tax at his personal rates on all UK source income. That individual can transfer land and other UK sources of income to a company to avoid higher rate income tax. He can also transfer foreign sources of income to a company in order to avoid tax on the remittance basis. A sale to an offshore company in return for debentures may be suitable. This was common planning before the introduction of the TAA provisions in 1936.

If the individual later becomes UK resident he does not retrospectively become liable for income accruing while non-resident. This is consistent with the usual IT position.[23]

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21 This is clear from the words of the section; if authority is needed, the point was assumed in *Herdman v IRC* 45 TC 394 at p.412: "Some time after making this transfer of shares the Respondent became ordinarily resident in Northern Ireland and " ... [s.720] *then* applied".

22 Of course, CGT, VAT, IHT, and SDLT all need consideration.

23 See 9.22 (Income arising when non-resident, remitted when resident).

18.5.2 *Transferor not ordinarily resident when transfer made*

The intention of those responsible for the legislation was that s.720 should only apply if the transferor was ordinarily resident in the UK at the time of the transfer.[24] This was eventually upheld in *IRC v Willoughby*[25] reversing *Herdman v IRC* 45 TC 394.

The position now is governed by s.720(5) ITA:

> It does not matter for the purposes of this section ...
> (b) whether the individual is ordinarily UK resident at the time when the relevant transfer is made ...

Thus non-residence at the time of the transfer is not a defence: s.720 may apply to any person after he becomes ordinarily resident, regardless of residence at the time of the transfer. This applies to income arising from 26 November 1996 regardless of the date of the transfer.[26]

18.6 Power to enjoy: Section 721 Condition A

Section 721(1) ITA provides:

> Income is treated as arising to such an individual as is mentioned in section 720(1) in a tax year for income tax purposes if conditions A and B are met.

I refer below to "**s.721 conditions A and B**", to avoid confusion with the myriad other conditions in the ITA. Section 721(2) sets out condition A:

> Condition A is that the individual has power in the tax year to enjoy income of a person abroad as a result of—
> (a) a relevant transfer,
> (b) one or more associated operations, or
> (c) a relevant transfer and one or more associated operations.

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24 "There has to be a transfer of assets abroad by an individual resident in this country." (W.S. Morrison, then Financial Secretary) 313 HL Official Reports 5th series col 685, cited in *IRC v Willoughby* 70 TC 57 at p.113.

25 70 TC 57.

26 Also see 19.8.1 (Transferor not ordinarily resident; pre-1996 income).

Once one has identified the transferor one asks whether he has "power to enjoy" income of the person abroad. "Power to enjoy" is elaborately defined and has given rise to a large case law. But in practice there is not often an issue here. In outline, the transferor has "power to enjoy" if he may possibly enjoy any of the income of the person abroad, or if he is able to control the application of the income. A transferor has no power to enjoy if he (and his spouse/civil partner) are excluded from benefit and have no power of control. A widow of the transferor may be included as a beneficiary.

The test is slightly wider than that of a "settlor-interested" trust for the purposes of s.624 ITTOIA[27] though for most practical purposes they are the same. It is hard to see the reason for the distinction, but that is the patchwork nature of income tax.

Statutory tax indemnities do not confer a power to enjoy, see 19.4.10 (Reimbursement of tax under statutory indemnity)

On a transfer from a UK domiciled person to his foreign domiciled spouse, see 53.14 (Income tax planning for mixed marriages).

Section 722 ITA provides:

> **When an individual has power to enjoy income of person abroad**
> (1) For the purposes of section 721, an individual is treated as having power to enjoy income of a person abroad if any of the enjoyment conditions are met.
> (2) In subsection (1) "the enjoyment conditions" means conditions A to E as specified in section 723.

I refer below to "**enjoyment conditions**" A to E to distinguish them from the myriad other conditions in the ITA.

Section 722(1) states that an individual is *treated* as having power to enjoy if any of the five conditions is satisfied. It is considered that this is a comprehensive definition of "power to enjoy" but it is impossible to think of any power to enjoy (in the general sense) which does not also fall within one of the five conditions, so the point is academic.

18.6.1 *Enjoyment condition A: income in fact dealt with to benefit T*

Section 723(1) provides:

27 See 16.3 (Meaning of "settlor-interested").

> Condition A is that the income is in fact so dealt with by any person as to be calculated at some time to enure for the benefit of the individual, whether in the form of income or not.

The nuance of this un-lawyer-like language was discussed by the Special Commissioners in *Botnar v IRC*:

> 222. [Enjoyment condition A] is concerned with how particular income is dealt with when it arises. [Counsel for the taxpayer] however conceded that this is not confined to its immediate handling on receipt or even to what happens in the year of assessment, if for example it is received late in the year, but that we should look at how it is dealt with within a reasonable time of receipt. ...
> 224. It seems to us that, when the word "calculated" is considered in the context that it refers to income which is "in fact so dealt with", the meaning "likely" is to be preferred to "thought out" in the sense of "intended"; however we are not sure that either "likely" or "intended" gives exactly the same flavour as "calculated". "Calculated" here combines an element of objectivity with an element of forethought.
> 225. It may not however make much difference because if any income was intended to enure for the benefit of Mr. Botnar it is obviously more probable that it was likely to so enure and that it would be seen objectively as likely to so enure.[28]

18.6.2 *Enjoyment condition B: income increases value of T's asset*

Section 723(2) ITA provides:

> Condition B is that the receipt or accrual of the income operates to increase the value to the individual—
> (a) of any assets the individual holds, or
> (b) of any assets held for the individual's benefit.

First one must identify assets held by T or "for his benefit". Having identified the assets, one asks whether the receipt or accrual of the income operates to increase the value of those assets.

The concept of "assets held by T" is straightforward but what about

28 72 TC 205. The wording is also discussed *obiter* in *Vestey v IRC* 54 TC 503 at p.555.

assets held "for his benefit"? In *Howard de Walden v IRC* 25 TC 121 a promissory note held by trustees on trust for T for life was considered to be held "for his benefit". One could reach the same result by a different route since T's life interest in the note was itself an "asset" held by T. If the asset is held on a discretionary trust under which T is merely a beneficiary, it is probably not held "for his benefit". What if the asset is held on interest in possession trusts for T subject to an overriding power of appointment?

The second requirement is that the receipt or accrual of income must increase the value of the asset. This also arose in *Howard de Walden v IRC*. Here T transferred assets to offshore companies and held (1) a life interest in promissory notes issued by the companies and (2) the benefit of debt due from the companies (T had lent money to the companies).[29] The Court of Appeal held:

> The receipt of the income by each company operates to increase the value of the notes and of the deposit debt...

But it is a question of fact in each case.[30] If a debt is sufficiently covered by existing assets of a company, the receipt of further income by the company does not increase the value of the debt.

18.6.3 *Enjoyment condition C: individual receives benefit*

Section 723 ITA provides:

> (3) Condition C is that the individual receives or is entitled to receive at any time any benefit provided or to be provided out of the income or related money.
> (4) In subsection (3) "related money" means money which is or will be available for the purpose of providing the benefit as a result of the effect or successive effects—
> (a) on the income, and
> (b) on any assets which directly or indirectly represent the income,
> of the associated operations referred to in section 721(2).

29 In some but not all cases T also held a few shares in the companies. The Court of Appeal ignored this because if it had held that T was caught only by virtue of these shares, T would not have been assessable on the income of all the companies.

30 *IRC v Brackett* is another example.

For the meaning of "benefit" see 19.4 (Benefit). For completeness, this question also arose in *Howard de Walden*. The Court of Appeal said:

> ... the payments made and to be made in respect of the notes and deposits are "benefits" within the meaning of (c) since "benefit" as defined ... includes a payment of any kind.

There are two issues here. Firstly, is the payment of a debt to T (or payment of the promissory note) a "benefit" in the general sense? The Court of Appeal rightly thought it was not, since they relied on the former definition clause. Secondly, did the definition clause extend the meaning of benefit to include a payment that is not a benefit in the normal sense? The Court of Appeal held that it did. However, this is no longer the law. The ITA no longer contains the definition of benefit on which the court relied.

18.6.4 *Enjoyment condition D: possibility of benefit*

Section 723 ITA provides:

> (5) Condition D is that the individual may become entitled to the beneficial enjoyment of the income if one or more powers are exercised or successively exercised.
> (6) For the purposes of subsection (5) it does not matter—
> (a) who may exercise the powers, or
> (b) whether they are exercisable with or without the consent of another person.

This would apply to a discretionary trust where T was a beneficiary (or could be added to the class of beneficiaries).

"Income" here includes any asset representing the income, even if that asset does not constitute the actual income (in the strict sense) of the person abroad. In *Vestey v IRC*:

(1) The individual could receive accumulated trust income. Walton J held that enjoyment condition D did not apply because what the individual

could receive was capital and so no longer "income".[31]

(2) The trust held a company. Walton J held that the individual had no power to enjoy the company's income within enjoyment condition D because what he could receive was dividends from the company and that was not the same as the "income" of the company.[32]

This is bizarre and in the House of Lords Viscount Dilhorne rejected it.[33] It is considered that Dilhorne's reasoning is to be preferred.

18.6.5 *Enjoyment condition E: control*

Section 723(7) provides:

> Condition E is that the individual is able in any manner to control directly or indirectly the application of the income.

"Control" means non-fiduciary control and so does not include the powers of control of a trustee or a protector with fiduciary powers:

> The question is whether he was able to control the application of the income, and to answer that question affirmatively it must in my judgment be possible to say at least that he was in a position to ensure that the trustees would act in accordance with his wishes without themselves giving any independent consideration and accordingly to act in disregard of their fiduciary duty.[34]

This is discussed by the Special Commissioners in *Botnar v IRC*:

> 260. It seems to us that due importance must be given to the words "able… to control" in [enjoyment condition E] bearing in mind the words "in any manner whatsoever, and whether directly or indirectly". An example of indirect control is to be found in *Lee v IRC* 24 TC 207,

31 *Vestey v IRC* 54 TC 503 at p.555.

32 *Vestey v IRC* 54 TC 503 at pp.562-3.

33 p.595. Strictly, Dilhorne only rejected point (1). He did not address point (2). But the reason is the same in both cases so it logically follows he rejected Walton's view on both points. No other judge considered this aspect.

34 *IRC v Schroder* 57 TC 94 at p.125, followed in the non-tax case *R v Radio Authority ex p. Guardian Media Group* [1995] 1 WLR 334 at p.345.

> where the taxpayer as majority shareholder could appoint and remove the directors of the company in question.
> 261. In our judgment the ability to control must go beyond an assumption that those controlling the companies will comply with the transferor's wishes and the fact that they do comply is immaterial. We accept the question posed by [Counsel], viz whether Mr. Botnar was in a position to ensure that the companies would act in accordance with his wishes.
> 262. There was in fact no material before us to indicate that Mr. Botnar could have done anything if Dr. Lenz had declined to do what he wanted. The position might have been different if Dr. Lenz was for example an employee who might have been dismissed in the event of failing to cooperate. There was however no evidence to suggest this. We are satisfied that the directors of the companies would have carried out his instructions. We have no doubt that Mr. Botnar was justified in assuming that Dr. Lenz would do what he wanted. However we do not consider that the mere fact that Dr. Lenz was in the saddle of the settlement meant that Mr. Botnar was able to ensure that the income would be applied for his benefit. On the authority of *Schroder* even decisive influence is not enough.
> 263. We readily accept [Counsel's] submission that Mr. Botnar wished to ensure that the shares in DUK later NUK would remain in friendly hands. In a sense it could be said that he did in fact control the settlement and the Companies because in fact Dr. Lenz did comply with his wishes: there was no evidence of any action by Dr. Lenz which was contrary to Mr. Botnar's wishes. That is not however the same as Mr. Botnar having the ability, even indirectly, to ensure that the income would be applied in accordance with his wishes.

In practice it is very rare that enjoyment condition E is satisfied and none of the other four enjoyment conditions would be satisfied. *Lee v IRC* 24 TC 207 (shareholder's power to appoint and dismiss directors) offers an example: if T transferred assets to a company under which his only interest was management shares conferring votes but no dividends or capital, he would satisfy enjoyment condition E. But T would also satisfy enjoyment condition B as company income would tend to increase the value of the voting shares (voting shares do have some value).

18.6.6 *Minority shareholding in offshore company*

If T holds a majority shareholding in an offshore company, he has power to enjoy all the income of the company since enjoyment condition E is satisfied. The same applies if T and his spouse together have a majority shareholding. What is the position if T has a minority shareholding, say, 10% of the ordinary shares? At first sight one might think that T has power to enjoy all the income of the company, since the income of the company increases the value of his minority shareholding. But it is suggested that the better view is that T has only power to enjoy one tenth of the company's income. This was assumed in *Bambridge v IRC* 36 TC 313.[35]

18.7 Power to enjoy: causation condition

It is not sufficient that the transferor has power to enjoy the income of the person abroad. A causation condition must also be satisfied. Section 721(2) ITA provides:

> Condition A is that the individual has power in the tax year to enjoy income of a person abroad *as a result of*—
> (a) a relevant transfer,
> (b) one or more associated operations, or
> (c) a relevant transfer and one or more associated operations.

Suppose:

(1) In 1970 A transfers an asset to a non-resident company wholly owned by B, who is not UK resident ("A's transfer").
(2) in 2000 B transfers the company to an offshore trust under which A may benefit ("B's transfer").

A has made a relevant transfer. However, in year 1 A is not within s.720 since he does not have "power to enjoy" the income of the company.

From 2000 onwards, A does have "power to enjoy". He does not have that power as a result of his transfer alone. However, B's transfer appears at first sight to be an associated operation in relation to A's transfer.[36] It seems at first sight that s.721 condition A is satisfied and A is taxable under s.720 on the income of B's trust! This clearly cannot be right, but

35 See R S Boyd, "Requiem for a Man of Straw" [1980] BTR 442 at p.457.
36 See 17.9 ("Associated operation": definition).

why not? This raises questions similar to those discussed in para 17.11.1 (Transfer from A to B followed by transfer from B to person abroad). Before the ITA, the legislation dealt with this by applying a more limited causation test. If B's transfer was an independent act, it "broke the chain of causation" and A's transfer was not the real or effective or operative cause.

From 2007/08, the foundation of that argument has been knocked away. But the courts will have to fill in the hole with a gloss, or the legislation simply does not work. It is suggested that B's transfer is not an associated operation, so A is not within s.720 if there is a "clean break" between A's transfer and B's transfer (the same test as applies elsewhere).

18.8 Income chargeable: Section 721 Condition B

Section 721(3) ITA provides:

> Condition B is that the income would be chargeable to income tax if it were the individual's and received by the individual in the UK.

It is not easy to think of income which would not be chargeable if received by a UK ordinarily resident individual in the UK. Perhaps the drafter had in mind a transferor who was ordinarily resident but not resident. If such a person can exist[37] they will benefit from condition B as (being non-resident) they are not chargeable on foreign income. In practice condition B will always be satisfied.

18.9 Amount of charge

Section 720 ITA provides:

> (2) Income tax is charged on income treated as arising to such an individual under section 721 (individuals with power to enjoy income as a result of relevant transactions).
> (3) Tax is charged under this section on the amount of income treated as arising in the tax year.

Unfortunately s.720 does not tell us *what* is the amount of income treated

37 Which is doubtful: see 3.10 (Ordinarily resident but not resident).

as arising. Section 721 does not answer the question either.[38] So construction and common sense must fill the gap.[39]

18.9.1 *Power to enjoy part of income of person abroad*

A person may have "power to enjoy" (as defined) over all the income of an offshore person even though his power to enjoy (in the natural sense of that expression) is limited to part[40] or even none[41] of the income. In such a case T is taxed on all the income: *Howard de Walden v IRC* 25 TC 121.

However, if T has power to enjoy (as defined) over only part of the income, T is only taxed on the income which he has power to enjoy:

> The only question is: What income of the non-resident does the resident individual have power to enjoy by reason of the transfer either alone or in conjunction with associated operations? It is that income which is deemed to be income of that individual for all purposes of the Income Tax Acts.[42]

18.9.2 *Person abroad with independent source of income*

Suppose:

(1) T transfers assets to an offshore company.
(2) The offshore company has two sources of income:

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38 Section 721 ITA provides:

> "(1) Income is treated as arising to such an individual as is mentioned in section 720(1) in a tax year for income tax purposes if conditions A and B are met.
> (2) Condition A is that the individual has power in the tax year to enjoy income of a person abroad as a result of—
> (a) a relevant transfer,
> (b) one or more associated operations, or
> (c) a relevant transfer and one or more associated operations."

39 See R.S. Boyd "Requiem for a Man of Straw" [1980] BTR 442. See also 17.13 (Capital receipts deemed to be income) and 17.14 (The amount of income of person abroad).

40 e.g. if T transfers shares to a company in which he holds debentures. If all the income of the company increases the value of the debentures just a little, T has power to enjoy over all the income within enjoyment Condition B.

41 e.g. if T has control within enjoyment Condition E.

42 *Congreve* 30 TC 163 at p.199.

(a) income from the assets transferred by T;
(b) income from other sources which have nothing to do with T.
(3) T has power to enjoy all the income of the offshore company.

The section does not say *what* income is treated as arising to the individual. Is it any income of the person abroad? Or is it only the income which arises as a result of the transfer of assets or associated operations?

RI 201 states:

> It has not been determined by the Courts whether all the income of the overseas person should be assessed, or only the income of that person to the extent that it arose by virtue or in consequence of the relevant transfer of assets and any associated operation(s). It has been the Revenue's practice (since the decision in *Vestey v IRC* 54 TC 503) to assess on the second of these two possible bases.

This must be so. The view that all the income of the person abroad is taxed is "quite ridiculous".[43] This view is now supported by s.714(2) ITA which provides:

> The charges apply only if a relevant transfer occurs, and they operate by reference to income of a person abroad that is connected with the transfer or another relevant transaction.

This clearly rejects the view that all income of the person abroad is caught. It suggests however that the measure of income caught is not that which arises as a *result* of the relevant transfer or associated operation, it is income which arises that is *connected* with the transfer or associated operation. "Connected" is not defined. However, while the wording was (presumably) designed to give HMRC scope to take one step back from the position stated in RI 201, I cannot think of a case where it would arise in practice.

43 Walton J in vehement form in *Vestey v IRC* 54 TC at 562, followed in *Carvill v IRC* [2000] STC (SCD) 143. The point had been left open in *Howard de Walden v IRC* 25 TC 119.

18.10 Enjoyment condition C – benefits

Section 724 ITA:

> **Special rules where benefit provided out of income of person abroad**
> (1) This section applies if an individual has power to enjoy income of a person abroad for the purposes of section 721 because of receiving any such benefit as is referred to in section 723(3) (benefit provided out of income of person abroad).
> (2) Despite anything in section 720, the individual is liable to income tax under that section for the tax year in which the benefit is received on the whole of the amount or value of that benefit.
> (3) But subsection (2) does not apply so far as it is shown that the benefit derives directly or indirectly from income on which the individual has already been charged to income tax for that tax year or a previous tax year.

This was introduced in 1969 and upset the reasoning of *de Walden* where repayment of a loan was held to fall within enjoyment condition C.[44] Since the charge is now on the value of the benefit, and the value of a payment for full consideration (such as the repayment of a loan) is nil, Condition C is not now satisfied.

In *Botnar* the Special Commissioners said:

> 245. ... Where the power to enjoy arises the tax is charged not on the income which the taxpayer has power to enjoy but on the value of the benefit. This may bear no relationship whatsoever to the income of the non-resident as long as it originated from it even indirectly. We do not accept that [s 724 ITA] only operates where the benefit received in a year exceeds the relevant income.

It is considered that the charge is on the lower of the value of the benefit and the amount of income of the person abroad. The value of a benefit in excess of the income does not come into charge, and if the transferor has power to enjoy the income apart from enjoyment condition C, then this

44 See 18.6.3 (Enjoyment Condition C: individual receives benefit).

provision does not apply.[45]

18.11 Transferor receives capital sum

Sections 727 and 728 ITA must be read together:

> **727 Charge to tax on income treated as arising under section 728**
> (1) The charge under this section applies for the purpose of preventing the avoiding of liability to income tax by individuals who are ordinarily UK resident by means of relevant transfers.
> (2) Income tax is charged on income treated as arising to such an individual under section 728 (individuals receiving capital sums as a result of relevant transactions).
> (3) Tax is charged under this section on the amount of income treated as arising in the tax year.
> (4) The person liable for any tax charged under this section is the individual to whom the income is treated as arising. ...
> **728 Individuals receiving capital sums as a result of relevant transactions**
> (1) Income is treated as arising to such an individual as is referred to in section 727(1) in a tax year for income tax purposes if—
> (a) income has become the income of a person abroad as a result of—
> (i) a relevant transfer,
> (ii) one or more associated operations, or
> (iii) a relevant transfer and one or more associated operations, and
> (b) the capital receipt conditions are met in respect of the individual in the tax year (see section 729).

Section 727 ITA is an independent charging section. Lord Greene correctly explains the purpose of this in *Howard de Walden v IRC* 25 TC at p.135:

> The provision was made ... to meet devices by which a transferor took care to give himself no "power to enjoy" any income of a non-resident transferee company within the meaning of [s.723 ITA], but obtained the money he required, for example, by borrowing from the company, all the shares being vested (for example) in his children.

45 See "Section 739 and benefits in kind", Robert Venables QC, OTPR Vol 11 Issue 3 p.1.

In practice it is rare for s.727 to apply in a case where s.720 does not, that is, the transferor receives a capital sum without having power to enjoy. An example would be a non-resident trust or company making an (arm's length) loan to a settlor or transferor who was excluded from benefit.

Many of the rules applying to s.720 also apply to s.727. In ITA they are set out twice in full, but I need not discuss them again here. In particular, s.727(2) restricts the charge to the transferor (just as s.720).

18.11.1 *Relationship of s.720 and s.727*

In *Vestey v IRC*, Walton J said:

> These subsections [now ss.720 and 727 ITA] are ... concurrent and not cumulative. A person cannot be taxed in any one year on the same sum under both [s.720 and also s.727]. Like Warren Hastings, the Crown, in making this concession, doubtless stood amazed at its own moderation ... but make it it did.[46]

18.12 The capital receipt conditions

Section 729(1) ITA provides:

> For the purposes of section 728(1), the capital receipt conditions are met in respect of the individual in a tax year ("the relevant year") if—
> (a) either—
> (i) in the relevant year the individual receives or is entitled to receive any capital sum, whether before or after the relevant transfer, or
> (ii) in any earlier tax year the individual has received any capital sum, whether before or after the relevant transfer, and
> (b) the payment of that sum is (or, in the case of an entitlement, would be) in any way connected with any relevant transaction.

18.12.1 *"Receives"*

"Receives or is entitled to receive" is glossed in s.729(4) ITA:

46 54 TC 503 at p.556.

> For the purposes of subsection (1), a sum is treated as a capital sum which the individual ("A") receives or is entitled to receive if another person receives or is entitled to receive it—
> (a) at A's direction, or
> (b) as a result of the assignment by A of A's right to receive it.

18.12.2 *"A capital sum"*

"Capital sum" is defined in s.729(3) ITA:

> In subsection (1) "capital sum" means—
> (a) any sum paid or payable by way of loan[47] or repayment of a loan, and
> (b) any other sum paid or payable—
> (i) otherwise than as income, and
> (ii) not for full consideration in money or money's worth.

In *Botnar v IRC* 72 TC 205 at [266] the Special Commissioners say:

> In our judgment the entitlement to use the flat is not a capital sum within the definition in [s.729(3)]; in particular we hold that the entitlement to use was not a "sum" within any normal use of English.

18.12.3 *Loans*

Section 729(2) ITA provides relief for loans which are repaid:

> But subsection (1)(a)(ii) does not apply merely because of the receipt of a sum by way of loan if the loan is wholly repaid before the relevant year begins.

18.12.4 *"Connected with any relevant transaction"*

In *Fynn v IRC* 37 TC 627:

(1) In 1948 T transferred assets to an Irish company ("the transfer of assets").
(2) The company charged the asset for a debt ("the charge").

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47 "Loan" is a fairly narrow term and does not include a purchase price left unpaid: *Ramsden v IRC* 24 TC 515.

(3) In 1952, T lent the company £12,000 ("T's loan")

T was entitled to receive a capital sum (repayment of T's loan). However, this had no "connection" with the transfer of assets or the charge (an operation associated with the transfer). So s.727 did not apply.

This is the only use of the expression "connected with" in the TAA provisions (though the definition of associated operations uses the comparable concept "in relation to"). "Connected with" is of course a concept used in other anti-avoidance provisions.[48]

18.12.5 *What income is caught by s.727?*

If the conditions of s.727 are satisfied the question arises as to whether the charge applies to:

(1) historic income: i.e. past income up to the year in which the capital sum is received; or
(2) current year income: income of the year in which the capital sum is received; or
(3) future income: income of the year in which the capital sum is received and subsequent years.

The question also arises whether the charge is limited to the value of the capital sum. In *Vestey v IRC* 54 TC 503, Walton J suggested that the charge under s.727 was limited to the amount of the capital sum. This was rejected by the two judges in the House of Lords who considered the point, obiter. Lord Wilberforce said:

> It is "any income" of the foreign transferees which is deemed to be the income of the recipient of a capital sum, [*indeed of each and every recipient of any capital sum*,][49] small or large, whenever received. From these words there is no escape.

Lord Wilberforce did not, I think, express a view on these alternatives. Since s.727 refers to income which "has" accrued, solution (1) at first

48 See *Emery v IRC* 54 TC 607.
49 But these words are wrong since s.739 is limited to transferors.

seems the natural reading. However, Viscount Dilhorne preferred view (3):

> While the income of the non-resident trustees would be deemed to be the income of [the taxpayer] on her receipt of the £100,000 [capital sum] on 2 May 1966, *in that and subsequent financial years*, I see nothing in [s.739(3)] which gives it retrospective effect. It does not provide that the income of the non-resident in any year before the person receives or is entitled to receive is to be deemed to be that person's income.[50]

Retrospectivity seems unworkable since it requires an unlimited number of past years to be opened for review. This section could even apply to income accruing in years when the settlor was not ordinarily UK resident. So the view of Viscount Dilhorne seems preferable.

This is also the view of the rewrite team. ITA EN change 111 provides:

> Section 739(3) ICTA does not deem the capital sum to be income; instead, it takes income which has become payable to persons abroad as a result of the transfer and deems that income to be the transferor's.
> But the wording of section 739(3) of ICTA leaves the timing of the charge rather unclear. It reads:
>
> > Where, whether before or after any such transfer, such an individual receives or is entitled to receive any capital sum …
>
> Section 739(6) ICTA provides that income is not deemed to be the individual's under section 739(3) ICTA for any tax year "by reason only of his having received a sum by way of loan if that sum has been wholly repaid before the beginning of that year". Therefore income may be deemed to be the individual's in other cases where there has been an actual receipt of a capital sum in a previous tax year. But section 739 makes no provision about whether section 739(3) imposes a charge if the individual was merely entitled to receive a capital sum in a previous tax year. In practice, where entitlement to a capital sum has ceased HMRC do not pursue further liability under section 739(3). Section 729 ITA gives effect to this practice by providing that the individual must either receive or be entitled to receive a capital sum in the tax year or have received a capital sum in an earlier tax year.

Viscount Dilhorne's view (that current and future income is caught) raises

50 54 TC at p.594.

the spectre of a transferor being taxed for all time because he receives a small capital payment. Suppose:

(1) A trust under which a settlor has an interest, and under which he is taxed under s.624 ITTOIA or s.720 ICTA.
(2) A capital payment is made to the settlor. This is made free of income tax since all the trust income is taxed as his anyway.
(3) The settlor is then excluded from benefit.

It has been suggested in these circumstances that all future income arising in the offshore trust will be deemed to be that of the settlor. That would be absurd and in practice HMRC do not take that point.[51] It is suggested that since s.727 does not apply in a situation where s.720 applies, a capital payment made at that time must be disregarded. But this would allow avoidance. For instance:

(1) Trustees borrow and make a substantial capital payment to the settlor.
(2) The settlor is excluded.
(3) The trustees receive income subsequently to repay the borrowing.

Is it possible that that income is outside the scope of s.727?

The only way to construe the section which makes sense of these problems is to follow the view of Walton J that the charge under s.727 is limited to the amount of the capital sum.

18.13 Section 720 remittance basis

Section 726 ITA provides a relief which I call "**the s.720 remittance basis**". Section 726(1) provides:

> This section applies in relation to income treated under section 721 as arising to an individual in a tax year ("the deemed income") if—

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51 But there is no official statement to this effect. The Tax Law Rewrite Paper CC/SC (O5) 25 does state:

> "In practice, where entitlement to a capital sum has ceased HMRC do not pursue further liability under s.739(3) ICTA"

but it is assumed there that if the individual *actually* receives a capital sum, liability never ceases.

> (a) section 809B, 809D or 809E (remittance basis) applies to the individual for the year, and
> (b) the individual is not domiciled in the UK in the year.

In short, the relief applies to remittance basis taxpayers. Section 726(2) ITA defines the term "foreign" deemed income:

> For the purposes of this section the deemed income is "foreign" if (and to the extent that) the income mentioned in section 721(2) would be relevant foreign income if it were the individual's.

"The income mentioned in s.721(2)" is the income of the person abroad (or that part over which the individual has power of enjoyment). Section 726(3) ITA provides the relief:

> Treat the foreign deemed income as relevant foreign income of the individual.

This would not work by itself as the foreign deemed income (the s.720 deemed income) does not exist in the sense that the individual has not actually received anything which he could remit. So s.726(4) ITA provides:

> For the purposes of chapter A1 of part 14 (remittance basis), treat so much of the income within section 721(2) as would be relevant foreign income if it were the individual's as deriving from the foreign deemed income.

In short, the remittance basis applies as if the income accruing to the person abroad were the income of the transferor. There is a tax charge if the income of the person abroad is received/brought/used in the UK by the transferor or by a relevant person (in relation to the transferor).

It is desirable for trusts and companies within s.720 to segregate income and capital so that they can remit capital (IT-free) rather than income (chargeable at IT rates).

Suppose:

(1) Year 1: Income accrues to a company within s. 720. The transferor ("T") receives s.720 deemed income but that income is (un)taxed under the s. 720 remittance basis.

(2) Year 2:
  (a) T becomes non-resident.
  (b) The company distributes its income by way of dividend. T receives actual income (a dividend) but because this dividend is received in a non-resident year, it is not taxed either on receipt or when remitted to the UK.
(3) Year 3:
  (a) T becomes UK resident.
  (b) T remits that dividend to the UK.

The question is whether the dividend received in the UK in year 3 constitutes a remittance of the s.720 deemed income of year 1. Is the dividend which the individual received derived from the s.720 deemed income. The answer is that the dividend received is derived from the income of the person abroad, and so is taxable on receipt in the UK in year 3.[52]

The position is no better if T remits the dividend in year 2, as this is in principle caught by the temporary non-residence rules.

In short, one cannot "wash" income taxable on the s. 720 remittance basis by a distribution to T in a year of T's temporary non-residence. That view fits the object of s.720 which is to put the transferor in the same position as if he had not made the transfer: see *Chetwode v IRC* 51 TC 647.

18.13.1 *Pre-2008 position and transitional rules*

Before 2007/08 it is considered that there was no charge under s.720 if the foreign income is remitted to the UK by:

(1) the person abroad who receives it; or
(2) the transferor (if he receives the income outside the UK from the person abroad).

52 See s.726(4). This seems even clearer if one remembers that distribution relief would be available, had the dividend in fact been taxable; see 20.4 (Distribution relief).

This was actually sensible.[53] Needless to say, no reason was given for changing the position here.

Para 170 Schedule 7 FA 2008 provides:

> The amendments made by paras 161 to 179 have effect for the tax year 2008-09 and subsequent tax years.

Income accruing to a person abroad before 2008/09 and remitted after 2008/09 is not caught by s.726 as the condition in s.726(1)(a) is not met.[54] This is right and fair, since there was no charge on remittance before 2008 (though given the retrospective operation of so many of the 2008 reforms, it may have been an oversight).

18.14 Interaction of s.87 and s.720

As noted above, where a transferor receives a benefit from a trust s.731 does not apply. In principle therefore the benefit is a capital payment and is chargeable under s.87.

Where a transferor is a remittance basis taxpayer, there can be a double charge to tax on a remittance: the amount remitted may at the same time represent (1) deemed s.720 income and (2) deemed s.87 chargeable gains. The effective rate of tax could therefore be up to 68.8% (IT at 40% and CGT at 18% with another 10.8% interest surcharge, if applicable.)

Suppose trustees make a payment to a beneficiary out which constitutes

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53 See Taxation of Foreign Domiciliaries 6th edn para 15.10 (Critique of s.648 clawback).

54 Contrast the usual RFI remittance basis, where para 83 Sch 7 FA 2008 fills that gap: see 9.16.1 (Transitional rule for pre-2008 income/gains). HMRC may not agree. TA Remittance Guidance provides:
The provisions described in TAH 1223 have effect for the tax year 2008-09 and subsequent years. There are no specific transitional arrangements for introduction of the new provisions. As the income charge only looks at income arising to the person abroad in the tax year it should not be necessary to have regard to income of earlier years in determining whether there is an amount that is to be regarded as foreign deemed income. However if there is foreign deemed income then in considering any possible charge under Part 8 ITTOIA it will be appropriate to consider all sums remitted to the United Kingdom in the tax year even if they arise, for example, from income of periods prior to the introduction of these provisions. Those remittances will fall to be tested against the rules in Chapter A1 Part 14 ITA 2007 as to whether they are taxable remittances.

a remittance of s.720 deemed income. Is the payment is chargeable to income tax, so it is a non-capital payment? It is considered that the answer is, no, for the *benefit* is not chargeable to IT.

18.15 No indemnity for transferor

The transferor has no express statutory indemnity against the person abroad for tax paid under s.720. It is considered that no indemnity can be implied.

CHAPTER NINETEEN

TRANSFER OF ASSETS ABROAD: NON-TRANSFERORS

19.1 TAA and non-transferors – Introduction and terminology

The provisions can be divided into four parts. In the order in which they appear in the ITA they are: the charge, the fundamental s.732 conditions, computation and defences. This is not the most logical way in which the legislation could have been set out but it is convenient to follow the statutory order.

First, s.731 ITA imposes the charge:

> **731 Charge to tax on income treated as arising under section 732**
> (1) Income tax is charged on income treated as arising to an individual under section 732 (non-transferors receiving a benefit as a result of relevant transactions).
> (2) Tax is charged under this section on the amount of income treated as arising for the tax year. ...
> (3) The person liable for any tax charged under this section is the individual to whom the income is treated as arising. ...

The charge applies if income is treated as arising under s.732, to which we must turn as the second stage of our journey. Section 732(1) ITA sets out five sets of conditions. I refer to them as "**the fundamental s.732 conditions**". They are as follows:

> *(a) a relevant transfer occurs.*

I refer to this as "**the relevant transfer condition**".

> *(b) an individual who is ordinarily UK resident receives a benefit.*

This contains two aspects, the receipt of a benefit and residence. So far as the residence aspects are concerned, I refer to this as "**the ordinary residence condition**".

> *(c) the benefit is provided out of assets which are available for the purpose as a result of—*
> *(i) the transfer, or*
> *(ii) one or more associated operations.*

I refer to this as "**the benefit causation condition**".

> *(d) the individual is not liable to income tax under section 720 or 727 by reference to the transfer and would not be so liable if the effect of sections 726 and 730 were ignored.*

I refer to this as "**the transferor's s.731 defence**".

> *(e) the individual is not liable to income tax on the amount or value of the benefit (apart from section 731).*

I refer to this as "**the benefit liable to IT defence**".

Where there is a relevant transfer to a trust or company, and the motive defence and ss.720 and 727 do not apply, I describe this trust or company as being "**within section 731**".

If all five fundamental conditions are satisfied one moves on to s.732(2) ITA:

> Income is treated as arising to the individual for income tax purposes for any tax year for which section 733 provides that income arises.

The third stage is to compute the amount of income treated as arising: this is dealt with in s.733 ITA (and s.734).

Lastly, there are some defences to the charge: in particular the s.731 remittance basis and the motive defence.

The statute refers on many occasions to "income treated as arising under s.732". It is convenient to have a short label for this, and I call it "**s.731 deemed income**". (It might of course be called "s.732 deemed income" but the charge is under s.731.)

19.2 Relevant transfer condition

The first fundamental s.732 condition is the relevant transfer condition. Section 732(2) ITA provides:

> This section applies if—
> (a) a relevant transfer[1] occurs,

Despite the present tense ("occurs") this condition is met in a year if a relevant transfer occurred in an earlier year. Grammarians call this "the historic present".

19.3 Ordinary residence condition

The second fundamental s.732 condition requires ordinary residence. Section 732(2) ITA provides:

> This section applies if ...
> (b) an individual who is ordinarily UK resident receives a benefit,

If an individual receives a benefit in a year but is not ordinarily resident in the year there is no charge under s.731 in relation to that benefit in that year.

What if B later becomes UK resident? Suppose:

(1) Year 1: B is not ordinarily resident in the UK, but he receives a benefit.
(3) Year 2: B becomes ordinarily resident in the UK but receives no benefit in that year.

It is considered that the fundamental condition in s.732(1)(b) is still not met in year 2: the words "an individual who is ordinarily UK resident receives a benefit" mean that the individual must be ordinarily resident at the time that he receives a benefit.

Residence at the time that relevant income arises is not in principle necessary. Suppose

1 See 17.2 ("Relevant transfer").

(1) Year 1: B is non resident and relevant income arises.
(2) Year 2: B is UK resident and receives a benefit.

The ordinary residence condition is satisfied so there is in principle a charge under s.731 by reference to the income of year 1.

Now suppose:

(1) Year 1: B is ordinarily resident in the UK and receives a benefit. However, there is no relevant income (no income arises at all or it has all been distributed) so there is no charge under s.731.
(2) Year 2: B is not UK resident or ordinarily resident but relevant income arises.

It is suggested that the ordinary residence condition is not met: the words "an individual who is ordinarily UK resident receives a benefit" mean that the individual must be ordinarily resident at the time that the section applies, as well as being ordinarily resident at the time he receives a benefit." This view is supported by the implied territorial limitation of UK taxation; see 11.4 (Why does situs of source matter?). But if B returns to the UK in year 3 he may be subject to tax.

19.4 Benefit

The second fundamental s.732 condition requires (in short) that the individual receives a benefit. Section 732(1) ITA provides:

> This section applies if ...
> (b) an individual who is ordinarily resident in the UK *receives a benefit*.

The charge is by reference to the amount or value of that benefit. I here consider the meaning of "benefit" and valuation of benefits. The word benefit is very common in tax statutes and in other areas of law.[2] So there is no shortage of material for discussion, though it is always necessary to consider the word in its context. Most of the discussion here applies equally to the meaning and valuation of "benefit" in s.87 TCGA.

There is no statutory definition of benefit for the purposes of the TAA

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2 For discussion in a trust law context see *Drafting Trusts and Will Trusts*, Kessler & Sartin, 9th ed., para 13.12 (What does a settlor exclusion clause cover?).

provisions.[3] It is well established that "benefit" is a word of wide import. There are no valuation provisions for s.731,[4] so the value of a benefit means market value.

19.4.1 *Arm's length transaction*

A transaction for which the individual gives full consideration is not a benefit.[5] It does not matter if the other party is a connected person (e.g. a sale to or from a family trust or company).

What if the parties act at arm's length and have no gratuitous intent but owing to some mistake the individual gives less than full consideration? This is not a benefit.[6]

19.4.2 *Receipt or sale of equitable interest*

RI 201 states:

> For the purposes of [s.731 ITA] a benefit is treated as not including
> [1] either the giving[7] of a life interest to a beneficiary or
> [2] the receipt by a beneficiary of the proceeds of selling a life interest.

Point [1] (conferring a life interest) is not a benefit if the interest is

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3 The pre-ITA legislation stated that "benefit" included a payment of any kind: s.742(9)(c) ICTA. This had no practical effect, and has sensibly been omitted in the present legislation.

4 Contrast the elaborate valuation rules for employee benefits; this is another manifestation of the patchwork nature of IT.

5 This is self-evident; but if authority is needed, see *IRC v Lactagol* 35 TC 230 and *Wilson v Clayton* 77 TC 1.

6 *Wilson v Clayton* 77 TC 1 decided that this is the case for the purposes of employment-related benefits. Note the reference to arm's length transactions in the passage from *Cooper* cited at 19.4.8 (Benefit to which a beneficiary becomes entitled under terms of trust); the same should apply for s.731. For CGT the position is dealt with by statute, but only for the avoidance of doubt: see 38.7.4 (Arm's length transaction).

7 "Giving" a life interest is layman's language. The term must include the conferring of a life interest by exercise of a power of appointment. Presumably it also includes the conferring of a life interest by exercise of a power of advancement or re-settlement.

revocable (or else the value of the benefit is nil).[8] If the interest is not revocable, then its receipt is a benefit, but this is still outside the scope of s.731 because such a benefit is not "provided out" of trust assets,[9] and to tax such a benefit is outside the scheme of the Act.

Point [2] (receipt of proceeds of sale of a life interest) is outside the scope of s.731 because a sale at market value is not a "benefit" to the vendor, or because the value of the "benefit" (if there was one) is zero.[10] If the sale was for more than market value there is a benefit but the benefit is not provided out of trust assets so it is not within s.731.

Although RI 201 refers to a life interest, the same reasoning must apply to any equitable interest.[11]

19.4.3 *Sale of company within s.731*

The same reasoning applies on the sale of shares or securities in a company within s.731. This leads to an interesting anomaly:

(1) B holds shares in a company which has accumulated relevant income within s.731. B sells the shares. No charge arises under s.731 as B does not receive a benefit (even when he spends the proceeds of sale).
(2) Trustees hold shares in a company which has accumulated relevant income. They sell the company. The sale proceeds represent the relevant income[12] and so if the trustees appoint the proceeds to B, he receives a benefit taxable under s.731.

19.4.4 *Interest-free loan and enjoyment of asset in kind*

RI 201 continues:

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8 The Special Commissioners reached a similar conclusion in the context of (what is now) s.201 ITEPA: *Dextra Accessories v Macdonald* [2003] STC 749. The point was not appealed.

9 Likewise for s.87 TCGA purposes the benefit is not "from the trustees".

10 The drafter of FA 1984 Sch 14 para 5(4) reached the same conclusion for the purpose of (what is now) s.87 TCGA.

11 On a sale of an equitable interest, watch:
(1) CGT on the disposal of the interest; and
(2) TCGA Schedule 4A.

12 See 19.26 (Tracing relevant income).

> But it ["benefit"] is otherwise treated as including all benefits taken into account in determining whether an individual has power to enjoy income for the purposes of Section 739 ICTA [now s.720 ITA]. It therefore includes for example receipt of a loan at less than a commercial rate of interest, and the use of trust property at less than an open market rental.

Interest-free loans and use of property at less than full rent are benefits within s.731: *Cooper v Billingham* 74 TC 139. On valuation of that benefit see "Loans to Beneficiaries of Offshore Trusts – The Value of the Benefit", David Williams, OTPR Vol 1, issue 3, p.35 and *IRC v Botnar* [1998] STC at pp.81–85.

19.4.5 *Loan (not to life tenant): interest paid at commercial rate*

A simple way of avoiding s.731 is:

(1) a trust within s.731 makes a loan at a market rate of interest;
(2) if appropriate, provide the beneficiary with funds to pay the interest; and
(3) the beneficiary pays the interest.

Take care that the interest does not have a UK source,[13] and watch *Furniss v Dawson*. The same can be done for the use of property in kind provided the property is not in the UK.

19.4.6 *Loan (not to life tenant): interest rolled up*

What if interest at a commercial rate is rolled up unpaid? There is no income tax charge on unpaid interest: *Dewar v IRC* 19 TC 361. In principle there is still no benefit (and so no tax charge under s.731). However, if the intention is that the interest will never be paid, the provision for payment of interest is a sham and ineffective for tax purposes. There are many trust law issues: do the trustees have power to make the loan? Unwinding the arrangement after the death of the beneficiary needs careful thought.

13 See 11.11 (Interest: where is the source).

19.4.7 *Interest-bearing loan to life tenant*

It is impossible to have an interest-bearing loan to a life tenant, under a transparent *Baker*-type[14] trust, because a person cannot pay interest to himself. Accordingly one cannot avoid a charge on a benefit in kind by purporting to charge interest, whether the "interest" is purportedly paid[15] or purportedly rolled up.[16] It would be different if interest was payable after the death of the life tenant or if the loan was issued at a discount instead of at interest.

There is a school of thought that maintains (to my mind over-optimistically) that interest-bearing loans to life tenants offer a solution to the problem of extracting trust funds free from s.731 ITA and s.87 TCGA. HMRC do not take that view.

19.4.8 *Benefit to which a beneficiary becomes entitled under terms of trust*

Suppose:

(1) A beneficiary is entitled to trust property absolutely subject to satisfying some contingency (e.g. attaining the age of 25).
(2) The contingency is satisfied (the beneficiary reaches 25 and becomes entitled to the trust property).

There is a "capital payment" for the purposes of s.87 TCGA: see s.97(2) TCGA. There is no equivalent provision in the transfer of asset rules. However, it is considered that the beneficiary does receive a "benefit"[17]

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14 It would be different if the trust was a non-transparent *Garland*-type trust. See 11.15 (Income from IP-type trusts: identifying the source).

15 Even if the parties go through a ceremony under which:
(1) the life tenant pays "interest" to the trustees; and
(2) the trustees return it to the life tenant.
Even if the parties do this there is no IT charge on the "interest": *Styles v New York Assurance* 2 TC 460.

16 However, if interest accrues unpaid and the life tenant dies, the position alters and outstanding interest becomes payable to the trust (unless Apportionment Act 1870 principles apply, which will be rare).

17 It is generally agreed that repayment of an interest-free loan is a benefit for the purposes of s.624 ITTOIA. (The point was conceded in *Jenkins v IRC* 26 TC 295 and the concession was held to be correct in *Wachtel v IRC* 46 TC 543. The issue remains (just) arguable in the Court of Appeal.) However, these cases did not have

and the value of the "benefit" is equal to the value of the trust property. The concepts of "value" and "benefit" can (just) be stretched wide enough to support this conclusion[18] and any other view would be inconsistent with the scheme of the provisions. This view is supported by *Cooper v Billingham* 74 TC 139 CA at [39]:

> The whole scheme of the legislation requires the Court to see what benefit a beneficiary actually receives, in cash or in kind, otherwise than as income or under an arm's-length transaction. Any pre-existing beneficial interest belonging to the beneficiary is irrelevant. The Judge dealt with this point shortly[19] but there was no need for him to say more.

Likewise, if L is entitled to a life interest, and a trust asset is transferred to L, the value of the benefit received is the value of the asset, not the value of the reversionary interest in the asset.[20]

19.4.9 *Benefit on liquidation or redemption of shares or securities*

A similar point arises where:

(1) A shareholder holds shares in a company within s.731.
(2) The shareholder receives assets of the company on the liquidation of the company or on the redemption of its shares.

It is arguable that the shareholder does not receive a "benefit" since he merely receives the property to which he is entitled in the liquidation or redemption; or (which comes to the same thing) that the value of the "benefit" is nil. After all, a sale of the shares would not be a benefit, and is commercially similar. And no-one would say that there is a benefit for the purposes of the income tax benefit in kind rules. On the other hand, the liquidation is analogous to becoming entitled under a trust. However,

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to consider what was the value of the benefit.

18 Contrast *R v Allen* [2000] 2 All ER 142 [2000] 1 Cr App R(s) 497 accessible *www.kessler.co.uk*, where the Court of Appeal stretched the word in a comparable way in order to uphold a confiscation order.

19 The judge said: "... The recipient's existing interest under the trust has to be left out of the calculation for the purpose of valuing the benefit ...", 74 TC at p.155.

20 This was stated (*obiter*) by the judge in *Cooper v Billingham* 74 TC 139 at p.155. It is the converse of the rule that the receipt of a life interest is not a benefit.

once again, the better view, consistent with the scheme of the Act, is that the receipt of funds from the company is a "benefit" for the purposes of s.731. Similar points apply on the redemption of debt securities.

19.4.10 *Reimbursement of tax under statutory indemnity*

SP 5/92 provides:

> 8 The settlor's right, under TCGA 1992 Sch 5 para 6, to reimbursement (or any payment in reimbursement) of tax paid under that Schedule is not regarded as creating an interest in a trust for the settlor under the provisions of [Chapter 5 part 5 ITTOIA] where the settlor, the settlor's spouse, and any companies in which they are participators cannot otherwise benefit from the trust, eg where the only beneficiaries are the settlor's children. Similarly, this statutory right to, or payment in, reimbursement is not regarded as bringing the settlor within the provisions of [s.633 ITTOIA, and the TAA provisions], nor as a capital payment for the purposes of TCGA 1992 s 97.
> 9 Further, this statutory right is not regarded as a reservation of benefit for inheritance tax purposes; nor is a provision in the trust deed either requiring the trustees to recognise the settlor's right to reimbursement under TCGA 1992 Sch 5 para 6 or to reimburse the settlor. But where a settlor does not pursue the statutory right to reimbursement, the failure to exercise this right may give rise to an inheritance tax claim under IHTA 1984 s 3(3), in which case the usual rules for lifetime transfers would apply.
> 10 A provision written into a settlement deed requiring the trustees to recognise the settlor's right to reimbursement under TCGA 1992 Sch 5 para 6, or to reimburse the settlor, is not, of itself, regarded as giving the settlor an interest in the settlement for the purposes of Sch 5, nor as bringing into play the provisions of [s.624 ITTOIA, and the TAA Provisions].

HMRC have suggested that this does not apply if reimbursement is made before the settlor has paid the tax for which he needs reimbursement. But it is submitted that there is never a benefit (or the value of the benefit is nil) when trustees pay a sum to a settlor in a *bona fide* settlement of a claim or prospective claim for reimbursement.[21]

19.4.11 *Benefit from trust/company under court order in divorce proceedings*

A court sometimes orders a trust or company within s.731 to transfer property to the spouse ("W") of the settlor/principal beneficiary ("H"). Assume that the parties are acting at arm's length, which will normally be the case. Is this a benefit?

It is important to understand the family law background, as to which see 10.15.1 (Is a transfer on divorce for consideration?).

If there were a tripartite agreement whereby the trust transfers assets to W in consideration for W giving up a claim against H, then the transfer from a trust to W would not be a benefit to W (who gives consideration) but it would be a benefit to H.

If the transfer is under a court order, including a consent order or Tomlin order, HMRC accept there is no consideration for it. Nevertheless it is suggested there is no benefit to W (or the value of the benefit is nil). Even though there is no consideration (a contract law concept) W does not gain anything. She merely receives what the court finds she is entitled to. For similar reasons H does not receive any benefit from the transfer either. The scheme of the legislation does not require "benefit" to be given an extended meaning. If (contrary to my view) there is a benefit, the benefit is not received as a result of the transfer and associated operations. There is a third argument if needed. The court only has power to make an order against H. It has no power to make an order against the trust.[22] In making the order, the court is effectively deciding that the trust or company within s.731 does not exist. On that basis it is impossible for there to be a charge under s.731 (or under s.87 TCGA).

If this were wrong the benefit is as much a benefit to H as a benefit to W; the fact that it is unclear which of H or W receives the benefit strongly suggests there is no benefit to either H or W.

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21 In practice this is an issue for s.87 but not for s.731 (because the settlor will be the transferor and qualify for the transferor's s.731 defence in any event). For other issues relating to reimbursement, see 19.20 (Relevant income used to pay expenses); 58.21 (Failure to exercise right of reimbursement).

22 There is a power to vary nuptial settlements, but I assume that power is not exercised.

19.4.12 *Payment of IHT*

No individual receives a benefit when trustees pay IHT charges on the trust. This is the case for the IHT 10-year charges and the IHT charges on the death of a life tenant with an estate, but it is necessary to consider them separately:

(1) The IHT 10-year charges are payable by the trustees of the settlement concerned: s.201(1)(a)(IHTA).
Beneficiaries[23] who receive capital payments are also liable for the IHT, but:
(a) they have a right to recover from the trust fund: s.212 IHTA.
(b) Also they are only liable if the tax remains unpaid after it ought to have been paid: s.204(5) IHTA 1984.
Accordingly the payment of IHT 10-year charges by the trustees (or by anyone else) is not a benefit to any individual beneficiary.
This is so even if that beneficiary was (secondarily) liable for the tax under s.201(1).

(2) The IHT charge on the termination of an estate if (during the life of the life tenant or on the death of a life tenant is likewise payable by the trustees of the settlement concerned: s.201(1)(a) IHTA.[24] But the same points apply:
(a) The life tenant has a right to recover from the trust fund: s.212IHTA.
(b) The life tenant is only liable if the tax remains unpaid after it ought to have been paid: s.204(5) IHTA 1984.
Accordingly the payment of IHT by the trustees (or by anyone else) is not a benefit to the life tenant. It cannot be a benefit to be relieved of a secondary liability of this kind, where one has an effective right of indemnity. Further, in the case of a wide common form trust, even if the class of beneficiaries as a whole may be said to receive a benefit; no individual receives a quantifiable benefit.

23 For non resident trusts, settlors are also liable.
24 In this case the life tenant is also liable for the IHT, under s.201(1)(b).

19.5 Who is the recipient of a benefit?

It is important to identify the recipient of a benefit because the individual who receives the benefit is the one who is taxable. It is especially important where some beneficiaries are and others are not UK resident or domiciled, because then the identity of the recipient may affect not only who pays the tax but whether any tax is payable at all. In particular, where a married or unmarried couple of mixed domicile are both beneficiaries under a trust, there is in principle scope for tax saving by arranging that the benefit is received by the non-domiciled beneficiary (and so can qualify for the s.731 remittance basis). The documentation in these circumstances is very important.

For the purposes of s.87 TCGA charge, the concept of "receipt" is explained by s.97(5) TCGA.[25] There is no statutory equivalent for s.731 but it is suggested that the same rules apply: s.97(5) merely states the natural meaning of "receipt".

Suppose trustees pay school fees for an individual's minor children. The children receive the benefit. The parent merely receives an intangible, non-financial advantage.[26] That is not a "benefit" for the purposes of s.731. Where the parent is under a legal obligation to pay school fees for his children (such as may arise on a divorce or in other family law proceedings) there is a "benefit" to the individual but the benefit is outside the scope of s.731 because it is merely incidental.[27]

Suppose a house (or chattels) is provided to a life tenant who then allows his spouse (or partner or children) to live there (and to enjoy the chattels). The same analysis applies. The indirect benefit which the spouse (or partner or children) receive is not a "benefit" for the purposes of s.731, or, alternatively, the benefit is outside s.731 as it is merely incidental.

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25 See 38.8 (Receipt by a beneficiary).

26 This assumes that the contract is between the school and the trustees. If the parent is personally liable to pay the school, and the trustees meet that liability, then the parent has received a benefit.

27 Similar issues arise in relation to a settlor exclusion clause which prevents trustees from applying property for the "benefit" of the settlor, and the authorities are reviewed in *Drafting Trusts and Will Trusts*, Kessler & Sartin, 9th ed., para 13.12 (What does a settlor exclusion cause cover?).

19.6 Benefit causation condition

The third fundamental s.732 condition is the benefit causation condition. Section 732(1) ITA provides:

> This section applies if ...
> (c) the benefit is provided out of assets which are available for the purpose as a result of—
> (i) the transfer, or
> (ii) one or more associated operations ...

There are two alternative conditions here:

(i) the benefit is provided out of assets which are available for the purpose as a result of the transfer; or

(ii) benefit is provided out of assets which are available for the purpose as a result of associated operations.

I refer to these as benefit causation conditions (i) and (ii). They are comparable to the relevant transfer causation conditions. Thus, not every benefit that an individual receives falls within s.731.

19.6.1 *Benefit to B1 used by B1 to benefit B2*

Suppose:

(1) A discretionary trust within s.731 has accumulated relevant income.
(2) In 1970 a beneficiary ("B1"), receives a trust asset ("B1's asset"). Although B1 receives a benefit assume B1 does not pay tax under s.731 because he is non-resident, or qualifies for the s.731 remittance basis.[28] This seems on a simple reading to be an associated operation (in relation to the transfer of assets to the trust).
(3) In 2000 B1 (independently and not as part of a prior arrangement)

28 Although strictly the position of B2 is the same even if B1 *is* taxed on his benefit, either as a capital benefit under s.731 or as an income benefit under ITTOIA.

gives the asset to another beneficiary[29] ("B2") who is UK resident.

B2 has received a benefit. Benefit causation condition (i) is not satisfied. However, it seems at first sight that benefit causation condition (ii) is satisfied, so B2 is at first sight subject to tax under s.731. This clearly cannot be right; but why not? It is necessarily part of the scheme of s.731 that when one beneficiary ("B1") receives a benefit, and uses the benefit to benefit another ("B2") only the first benefit counts. Otherwise what should be regarded in economic reality as a single benefit may give rise to a series of tax charges as it passes from one beneficiary to another and to another.[30] But why is this the case? The best answer is that the operations are not associated. Mere historic association is not enough. These must be something more.[31] It is suggested that the principles to apply are those of the "clean break" test.[32]

Consider a trust where the settlor ("S") is a beneficiary and the settlor wishes to make a payment to another beneficiary ("B"). A direct payment from the trustees to B may be within the scope of s.731. In that case the solution may be to make regular payments to S who may subsequently make a gift to B, but this can only succeed if the gift is genuinely independent, which may not be easy to arrange.

19.6.2 *Transfers between trusts*

Suppose:

(1) A trust ("trust 1") within s.731 has accumulated relevant income.
(2) Trust 1 transfers funds ("the transferred funds") to a new UK trust on similar terms ("trust 2").
(3) A beneficiary ("B") receives a benefit from trust 2 out of the

29 If B1 transfers the asset to a person ("C") who is not a beneficiary of the trust (in the sense that trust income cannot be used to benefit C) then C cannot be subject to tax under s.731 as there is no relevant income in relation to C. But in a standard form discretionary trust there is a wide power to add beneficiaries; so trust income is relevant income in relation to every person in the world (whether or not they are specifically identified as "Beneficiaries" in the trust deed).

30 Assume there is sufficient relevant income.

31 The argument would be the same as in 17.11 (Person abroad receives income as indirect consequence of transfer).

32 See 58.4 (Gift from A to B followed by gift to trust by B).

transferred funds.

The transfer from trust 1 to trust 2 is an operation associated with the earlier transfer to trust A.[33] B has received a benefit and the benefit is provided out of assets which are available as a result of the transfer and the associated operation. So B is taxed under s.731. The benefit causation condition is satisfied.

Suppose trust 2 was an established trust with a trust fund ("fund 2"). If B receives a benefit from fund 2 he is not taxable under s.731 because that fund is not available as a result of the transfer of assets to trust 1.

It follows that a transfer between settlements will not in principle avoid s.731 charge. There is no reason why it should (except a misconceived analogy with s.90 TCGA).

19.7 Benefit causation condition: two transfers of assets

(1) A settlor by a single disposition transfers assets to a trust within s.731.
(2) Part of the trust fund is invested in assets which yield relevant income.
(3) Another part of the trust fund consists of a house occupied rent-free by B.

B pays tax on the benefit by reference to the relevant income. By contrast, suppose:

(1) A settlor by *two* separate transfers creates *two* trusts within s.731:
    (a) a trust which holds income-producing assets and accumulates relevant income; and
    (b) a trust which holds the family home.
(2) B enjoys the benefit of free occupation in the home.

B is not subject to tax under s.731 as there is no relevant income in relation to this benefit. Thus the use of two trusts may avoid a tax charge under s.731 which would have arisen if there were one.

Indeed, it is not necessary to use two trusts. The same applies if there are two separate transfers of assets to one trust.

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33 The transfer between trusts is not a clean break. After all, trustees are expected to pay close attention to the wishes of the settlor, and in doing so they are merely filling in the blanks" left by the settlor: see *Muir v Muir* [1943] AC 468.

19.8 Transferor's s.731 defence

The fourth fundamental s.732 condition is the transferor's s.731 defence. Section 731(2) ITA provides:

> This section applies if—...
> (d) [i] the individual is not liable to income tax under section 720 or 727 by reference to the transfer
> [ii] and would not be so liable if the effect of sections 726 and 730 were ignored ...

Section 732(1)(d)[ii] makes clear that this defence applies to a non-UK domiciled transferor even if he qualifies for the s.720 remittance basis.[34] This is sensible. There is no need to apply s.731 to a transferor to whom s.720 applies. The application of s.720 gives HMRC all they should need.

19.8.1 *Transferor not ordinarily resident when transfer made; pre-1996 income*

It has never been a requirement of s.731 that the transferor was ordinarily resident at the time of the transfer, but this was a requirement of s.720 until 1996.[35]

RI 201 provides:

> Similarly, a transferor of assets who is outside the charge to tax under Section 739 ICTA [now s.720 ITA] in respect of income arising before 26 November 1996 through being not ordinarily resident in the UK at the time of the transfer, is not assessed under Section 740 ICTA [now s.731 ITA].

This is looking at a transferor "T" (wherever domiciled) who:

(1) makes a transfer of assets before 26 November 1996;
(2) is not UK ordinarily resident when he made the transfer;
(3) later becomes UK ordinarily resident.

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34 See 18.13 (Section 720 remittance basis).
35 See 18.5.2 (Transferor not ordinarily resident when transfer made).

T was not taxable under s.720 until 26 November 1996. I refer to income arising before that date as "pre-1996 income". If T receives a benefit after 26 November 1996[36] he is not taxable under s.731. This is right because the transferor's s.731 defence does not apply to *income* liable to tax under s.720. It applies to an *individual* liable to tax under s.720. In the example, T (once ordinarily resident and after 26 November 1996) becomes an individual who is "liable to tax under s.720". This is something of a windfall for T, but of course non-transferors may be taxed as the pre-1996 income is relevant income.

19.8.2 *Transferor not ordinarily resident at other times*

RI 201 does not address the situation where T is outside the scope of s.720 only because he is not ordinarily resident for a period. Suppose:

(1) T is ordinarily resident when he makes the transfer;
(2) T is non-resident for a period ("the non-resident period");
(3) T returns to the UK.

The reasoning above shows that on these facts T is also outside s.731; he qualifies for the transferor's s.731 defence in relation to income of the non-resident period as well as the income accruing while resident.

19.8.3 *Spouse of transferor*

Section 714(4) ITA provides:

> In this Chapter references to individuals include their spouses or civil partners.

Accordingly the spouse/civil partner of the transferor also qualifies for the transferor's s.731 defence. This only applies during the life of the transferor as a former spouse/civil partner is not a "spouse" or a "civil partner".[37]

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36 I need not now consider the position if the benefit was received before 26 November 1996 but the result was probably the same.
37 See Appendix 1.2 (Meaning of "spouse") and 1.3 (Meaning of "civil partners").

19.9 Benefit liable to IT defence

The fifth fundamental s.732 condition is the benefit liable to IT defence. Section 732(1) ITA provides:

> This section applies if ...
> (e) the individual is not liable[38] to income tax on the amount or value of the benefit (apart from section 731).

For this purpose a UK resident foreign domiciled individual is "liable" to income tax on unremitted foreign income.[39] This question arises where an individual receives foreign income and the s.731 remittance basis does not apply.

Suppose:

(1) A discretionary trust within s.731 receives UK source income (or both UK and foreign source income).
(2) A UK resident foreign domiciled beneficiary ("B") receives income ("unremitted foreign trust income") from the trust.

B is potentially taxable on the unremitted foreign trust income but assume the income is not remitted, so no tax is due.

Can HMRC argue that B is subject to tax on the unremitted foreign trust income under s.731?[40] The answer is, no, because B is liable to IT on the benefit. By contrast, if B had received capital instead of income from the same trust, he would have been subject to tax on the benefit under s.731!

Of course, the word "liable" (like all words) takes its meaning from the

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38 The word in the pre-ITA legislation was "chargeable" not "liable" but the change has not altered (and has perhaps clarified) the position.

39 This might not seem to accord with the natural meaning of "liable"; but it is consistent with the well established rule that pension schemes and charities are "liable" to income tax for the purposes of DTTs even though they qualify for pension scheme charity exemptions; see Kessler & Kamal, *Taxation of Charities*, 6th ed., Key Haven, para 14.2.2 (Liable to tax). *Stonor v IRC* [2001] STC (SCD) 199 might be cited against this view but a Special Commissioners decision on other provisions, arguably obiter, and not fully argued, does not count for much. This view is also consistent with the rule that unremitted foreign income is "chargeable" to IT; see 38.7.1 (Definition of "capital payment").

40 The s.731 remittance basis is not in point if the benefit relates to UK source relevant income: see 19.33 (Section 731 foreign domicile defence).

context. So perhaps here HMRC may argue that unremitted foreign income is not "liable" to income tax, for the purposes of the benefit liable to IT defence. The answer is that there is no need to apply s.731 in a situation where the ordinary remittance basis regime applies. The RFI remittance basis regime gives HMRC all they should need. So it is considered that unremitted foreign income received by a UK resident individual is taxable, if at all, under ordinary principles and cannot be taxed under s.731. This result is consistent with the transferor's s.731 defence: s.720 applies to the exclusion of s.731.[41] Anti-avoidance provisions, like hypotheses, should not be multiplied unnecessarily.

19.10 Is a benefit within s.731 a capital payment?

The definition of "capital payment" for s.87 purposes is discussed in 38.7 (Capital payment). For present purposes the relevant part of the definition is that a capital payment is any payment "which is not chargeable to income tax on the recipient".

In the following discussion "**a non-capital payment**" is a payment which is not a capital payment.

19.10.1 *Benefit giving rise to s.731 charge in year of receipt*

The pre-ITA position was straightforward. Section 740 ICTA was a tax on the benefit.[42] If a person received a benefit which was subject to tax in the

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41 See 19.8 (Transferor's s.731 defence). A further objection to this HMRC argument is that there may be a double charge to tax:

(1) Tax under s.731 on receipt of the unremitted foreign trust income.

(2) Tax under general principles when the foreign trust income was later remitted to the UK.

Arguably, double counting relief applies: see 20.6 (Double-counting relief). But there is no provision allowing tax paid under s.731 to be reclaimed.

42 Section 740 ICTA provided:

"(1) This section has effect where-

(a) by virtue or in consequence of a transfer of assets, either alone or in conjunction with associated operations, income becomes payable to a person resident or domiciled outside the United Kingdom; and

(b) an individual ordinarily resident in the United Kingdom who is not liable to tax under section 739 by reference to the transfer receives a benefit provided out of assets which are available for the purpose by virtue or in consequence of the transfer or of any associated year of receipt, under s.740 (i.e. assume there was relevant income) then the benefit was a non-capital payment for CGT purposes.

It is not immediately obvious that the position is the same from 2007/08. For s.731 is not expressed as a charge on the benefit. It appears at first sight to be a charge on fictional, deemed income: the amount or value of the benefit is merely an element in the computation of the amount of the s.731 deemed income. However it cannot be the case that the same benefit gives rise to CGT on the benefit and deemed income on an amount equal to the benefit. A strained construction is needed to avoid absurdity. There are two possible solutions:

(1) Either (contrary to first appearances) s.731 is in fact a charge on benefits, not on deemed income; or
(2) The reference (in the definition of capital payment) to a payment being chargeable to IT should be read as including a benefit giving rise to deemed income.

Section 97(3) TCGA (see below) adopts the first view and so does s.734(1)(c) ITA.[43]. Ultimately it makes no difference for present purposes which view one takes but the better view is that s.731 is a tax on the benefit.

19.10.2 *Benefit matched to relevant income after year of receipt*

The pre-ITA position was straightforward. In the absence of express provision, a benefit which is not taxable under s.740 ICTA only for lack of relevant income might arguably have been a non-capital payment. But this

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operations.

(2) Subject to the provisions of this section, the amount or value of any such benefit as is mentioned in subsection (1) above, if not otherwise chargeable to income tax in the hands of the recipient, shall -

(a) to the extent to which it falls within the amount of relevant income of years of assessment up to and including the year of assessment in which the benefit is received, be treated for all the purposes of the Income Tax Acts as the income of the individual for that year;

(b) to the extent to which it is not by virtue of this subsection treated as his income for that year and falls within the amount of relevant income of the next following year of assessment, be treated for those purposes as his income for the next following year."

43 See19.12 (Section 733 computation when benefit subject to CGT).

argument was ruled out by s.97(3) TCGA. For convenience I set out the text of s.97(3) indicating the ITA amendments in track-change format:

> The fact that the whole or part of a benefit is by virtue of ~~section 740(2)(b) of the Taxes Act~~ section 733 of ITA 2007 treated as the recipient's income for a year of assessment after that in which it is received—
> (a) shall not prevent the benefit or that part of it being treated for the purposes of sections 86A to 96 and Schedule 4C as a capital payment in relation to any year of assessment earlier than that in which it is treated as his income; but
> (b) shall preclude its being treated for those purposes as a capital payment in relation to that or any later year of assessment.

Post ITA this wording is not apt because under s.731(on a first reading) a benefit is not "treated as the recipient's income". Section 731 is a charge on deemed income. But a strained construction is required to give effect to the obvious intention, that a benefit outside s.731 (for lack of relevant income) is a capital payment for CGT and it is considered that s.731 should be regarded as a tax on the benefit.

Thus if:

(1) a benefit is conferred,
(2) the benefit is not subject to s.731 in year of receipt for lack of relevant income

the benefit can be taxed as a capital payment in year of receipt. If:

(3) the benefit is not subject to s.87 in year of receipt (for lack of s.2(2) gains) the s.731 charge in the following year has priority over the s.87 charge in that year; and so on.

19.10.3 *Benefit where s.731 remittance basis applies*

A benefit which falls within s.731 but qualifies for the s.731 remittance basis is taxed on the remittance basis, but is nevertheless "chargeable" to tax, so it is a non-capital payment.

By contrast, s.731 does not apply at all a benefit which does not meet any of the five fundamental s.732 conditions (for instance a benefit to a transferor) and such a benefit is a capital payment.

19.10.4 *Benefit where motive defence applies*

The pre-2006 wording was that "Sections 739 and 740 *shall not apply*" where the motive defence applied, so it was clear that a benefit where the motive defence applied could be a capital payment.

Under the current legislation, where the motive defence applies, the individual who receives a benefit "is not *liable to income tax*" under the TAA provisions. It might be argued that the benefit is chargeable (even if the individual is not liable) but is considered that a benefit where the motive defence applies is a capital payment: it is not chargeable to IT within the meaning of the capital payment definition.

19.11 Computation of charge

19.11.1 *Introduction*

In outline, where an individual receives a benefit, s.731 imposes a charge on the lesser of:

(1) the value of the benefit; and
(2) the amount of relevant income in relation to that individual.[44]

However, the details are far more complicated than this outline suggests. The rewrite legislation is defectively drafted (it reproduces some defects from the source legislation and adds some new ones). The task here is to find a construction which (if somewhat loose) will yield a workable scheme of taxation.

The computation is governed by s.733. This is only a computation provision. It does not apply unless the five fundamental conditions of s.732 are met. I refer to the computation made under s.733 as "**the s.733 computation**". There are six steps in the computation. It can serve as a case study as to how much obscurity can be found in a computation presented as a series of short steps.

44 Contrast s.720, which in general imposes a charge on the whole of the income accruing to the person abroad.

19.11.2 *Step 1: Total Benefits*

In order to follow Step 1, we need to read it in the context of s.732 and the opening words of s.733

> **732(1)** This section applies if—
> (a) a relevant transfer occurs,
> (b) an individual who is ordinarily UK resident receives a *benefit*,
> (c) the *benefit* is provided out of assets which are available for the purpose as a result of—
> (i) the transfer, or
> (ii) one or more associated operations,
> (d) [in short - the individual is not the transferor]
> (e) the individual is not liable to income tax on the amount or value of the *benefit* (apart from section 731).
> ...
>
> **733(1)** To find the amount (if any) of the income treated as arising under section 732(2) for any tax year in respect of *benefits provided as mentioned in section 732(1)(c)* take the following steps.
>
> *Step 1*
> Identify the amount or value of *such benefits* received by the individual
> [1] in the tax year and
> [2] in any earlier tax years *in which section 732 has applied*.
> The sum of those amounts and values is "the total benefits".

I (slightly reluctantly) adopt the statutory terminology and refer to benefits within step 1 as **"Total Benefits".** I refer to benefits within Step 1[1] as **"present year Total Benefits"** and benefits within [2] as **"earlier year Total Benefits."**

There are two obscure references in Step 1:

(1) Which benefits are counted as Total Benefits? One does not identify *all* benefits received by the individual, but only "such benefits". The drafter has overlooked the ambiguity of the word "such" which ought only to be used when it refers to a clear antecedent:
   (a) On one view, "such benefits" refers back to the words in the first sentence of s.733(1): "benefits provided as mentioned in s.732(1)(c)". So "such benefits" refers to all benefits which meet the benefit causation condition.

(b) On another view,"such benefits" refers back to s.732(1) which uses the word benefit three times so "such benefits" means benefits in respect of which all five fundamental s.732 conditions are satisfied (not just the benefit causation condition.

The difference between the two views is, for instance, that on the first view an income taxable benefit can count as "such benefits" and on the second view an income taxable benefit cannot (because of the benefit liable to IT defence.) Likewise, on the first view a benefit received by a non-resident can count as "such benefits" but on the second view it cannot (because of the ordinary residence condition).

The second view is to be preferred as it yields more sensible results.[45]

(2) Which benefits from earlier years are Total Benefits? One does not identify *all such benefits* received by the individual, but only such benefits in tax years "in which s.732 has applied." It is not of course enough that *section 732 applies*, for the section no doubt applies every year to some taxpayer or other. Section 732 must apply having regard to the circumstances of the transfer or the individual in the earlier year.

If this is right, the definition of "Total Benefits" can be expanded to mean the following:

[1] *Present year total benefits* must meet the following conditions (in order to be "such benefits"):

(a) a relevant transfer has occurred
(b) an individual who is ordinarily UK resident ("B") receives a benefit in the present year
(c) the benefit is provided out of assets which are available for the purpose as a result of—
  (i) the transfer, or
  (ii) one or more associated operations,
(d) B is not the transferor; and
(e) B is not liable to income tax on the benefit (apart from section 731).

45 If one adopted the first view one could avoid the problems which arise by a generous application of s.743 ITA (no duplication of charges) but it is better to avoid that solution since the relief is depends on HMRC discretion.

[2] *earlier year benefits* must meet the following conditions (in order to be "such benefits" and to meet the requirement that s.732 applies in the year):
(a) The relevant transfer has occurred
(b) B was ordinarily UK resident in the earlier year and received a benefit in the earlier year ("the earlier year benefit").
(c) the earlier year benefit is provided out of assets which are available for the purpose as a result of -
(i) the same transfer as [1] (a) above, or
(ii) the same associated operations as [1] (c) above
(d) B is not the transferor, and
(e) B is not liable to income tax on the earlier year benefit (apart from section 731).

19.11.3 *Step 2: Total Untaxed Benefits*

"Total Untaxed Benefits" has a relatively commonsense definition. Step 2 provides:

> Deduct from the total benefits the total amount of income treated as arising to the individual under section 732(2) for earlier tax years as a result of the relevant transfer or associated operations.
> The result is "the total untaxed benefits".

We need a label to describe the deduction as it is impossible to follow a discussion which refers more than once to "the total amount of income treated as arising to the individual under section 732(2) for earlier tax years as a result of the relevant transfer or associated operations". I refer to the deduction as "**prior year s.731 income**".

A straightforward example is if:

(1) Year 1: B receives benefit £100.
(2) Year 2: B receives benefit £100.

The Totals Benefit is £100 + £100 = £200. But assuming in year 1 B was treated as receiving £100 s.731 income, then the prior year s.731 income is deducted so Total Untaxed Benefits are computed thus:

Total Benefits	£200
Prior year s.731 income	-£100
Total Untaxed Benefits	**£100**

Section 734 ITA provides for another deduction from Total Untaxed Benefit: since this only arises infrequently I deal with it separately below; see 18.12 (Section 733 computation when benefit subject to CGT).

19.11.4 *Steps 3 and 4: Relevant Income and Total Relevant Income*

Steps 3 and 4 concern relevant income and total relevant income, and are discussed below.

19.11.5 *Step 5: Available Relevant Income*

Step 5 provides:

> Deduct from total relevant income—
> (a) the amount deducted at Step 2 [ie prior year s.731 income], and
> (b) any other amount which may not be taken into account because of section 743(1) and (2) (no duplication of charges).
> The result is "the available relevant income".

The deduction in Step 5(b) is discussed in 20.6 (Double-counting relief).
What is the reason for the deduction in Step 5(a)? ITA EN explains a double taxation problem in the pre-ITA law:

> Section 740 of ICTA [now s.731 ITA] leaves several questions unanswered.
> It provides that
> [a] if the relevant income exceeds the benefit, the amount or value of the benefit is chargeable to income tax in the individual's hands,
> [b] but does not make provision about the treatment of the excess of the relevant income over that amount.
> [c] Taken literally and in isolation, section 740(2)(a) suggests that whenever a benefit is received the amount or value of the benefit must be compared with *all* the relevant income that has arisen on or after 10 March 1981, regardless of whether the receipt of previous

> benefits has involved charges by reference to that income before.[46]

For instance, if the relevant income is only £100, and T receives benefits of £100 annually, he would appear to be taxed each year on £100, so the relevant income in effect comes into charge again and again. I refer to this as **"the RI multiple counting problem"**. I confess I had not noticed the problem, but point [c] seems correct if one takes the words literally and in isolation, (which is of course never the right approach to a statute). The EN then give two independent reasons why no problem arose, that is, it identifies two pre-ITA solutions to the RI multiple counting problem:

> But
> [1] relevant income is defined as income that can directly or indirectly be used to provide a benefit in the tax year [ie in the year that the tax charge arises], and
> [2] section 744(1) and (2)(c)[47] of ICTA [now s.743 ITA] prevent the same relevant income being taken into account more than once.
> It is therefore considered that the *surplus* relevant income *(if it continues to be available)* has not been taken into account and so must be carried forward year by year until extinguished by a benefit or benefits. Section 733 of this Act gives effect to this view by providing [only] for *surplus* relevant income to be carried forward.[48]

Note that it is assumed in solution [1] that in order to identify the amount of relevant income, one asks whether income can be used to provide a benefit at the time the tax charge arises, ("if it continues to be available") not at the time that the relevant income accrues.

Example 1: one beneficiary

Suppose a trust with Total Relevant Income of £200 and:

46 Section 740(2) ICTA provided so far as relevant:
" ... the amount or value of any such benefit as is mentioned in subsection (1) above, ... shall— (a) to the extent to which it falls within the amount of relevant income of years of assessment up to and including the year of assessment in which the benefit is received, be treated for all the purposes of the Income Tax Acts as the income of the individual for that year".

47 The original erroneously reads: (2)(b).

48 Change 1113, p. 472; emphasis added.

(1) Year 1: B receives a benefit (£100) and £100 deemed s.731 income. Assume the benefit is not paid out of relevant income.
(2) Year 2: B receives another benefit (£200).

The computation in year 2 goes as follows:

Step 1: The Total Benefits of B are £300.
Step 2: The Total Untaxed Benefits of B is computed thus:

Total Benefits	£300
Prior year s.731 income	- £100
Total Untaxed Benefits:	**£200**

Steps 3 and 4: The Total Relevant Income is £200.
Step 5: The Available Relevant Income is computed thus:

Total Relevant Income	£200
prior year s.731 income	- £100
Available Relevant Income:	**£100**

Step 6: the amount of s.731 income in year 2 is the lower of Total Untaxed Benefits and Available Relevant Income = £100. That is fair and reasonable and tax law rewrite's solution to the RI multiple counting problem has worked.

Example 2: two beneficiaries

Now suppose a trust with Total Relevant Income of £200 and:

(1) Year 1: B receives a benefit (£100) and £100 deemed income under s.731.
(2) Year 2: C (not B) receives a benefit (£200).

The computation for C in year 2 goes as follows:
Step 1: The Total Benefits of C are £200.
Step 2: The Total Untaxed Benefits of C are £200 (nothing is deducted).
Step 5: Total Available Income = £200: There is no deduction from the Total Relevant Income under Step 5(a) because nothing is deducted at Step 2.

Here the Step 5(a) deduction does not prevent double taxation. The tax law rewrite team have only partly solved the RI multiple counting problem which (on a literal reading and taken in isolation) they identified. They have solved the problem where the *same* beneficiary receives benefits in different years. They have not solved it where *different* beneficiaries receive benefits in different years. Why is C not taxed on £200?

C must fall back on one of the two pre-ITA solutions identified by the tax law rewrite team:

(1) that distributed income ceases be relevant income (because it ceases to be available); so the amount of relevant income is only £100 (assuming B's benefit is a distribution of relevant income); or (if relevant income is not distributed):
(2) Step 5(b): double counting relief.

Solution (2) applies if the distribution to B did not consist of relevant income. It depends on HMRC discretion, but that was the position before the ITA rewrite, so nothing has changed.

Example 3: one beneficiary receives a distribution of relevant income

The second difficulty is that the rewrite team solution – a deduction for prior year s.731 income – does not link in with the first of the pre-ITA solutions to the RI multiple counting problem. Suppose a slight variant to example 1: a trust with Total Relevant Income of £200 and:

(1) Year 1: B receives a benefit (£100) and £100 deemed s.731 income. Assume the benefit *is* paid out of relevant income.[49]
(2) Year 2: B receives another benefit (£200).

The computation in year 2 goes as follows:

Step 1: The Total Benefits of B are £300.
Step 2: The Total Untaxed Benefits of B is computed thus:

Total Benefits	£300
Prior year s.731 income	- £100
Total Untaxed Benefits:	**£200**

49 For instance, trust income is accumulated and then paid to the beneficiary as capital.

Steps 3 and 4: The Total Relevant Income is £100 (because £100 has already been distributed and is not available to provide a benefit.)
Step 5: The Available Relevant Income appears to be:

Total Relevant Income	£100
prior year s.731 income	- £100
Available Relevant Income:	**£0??**

B should have £100 s.731 income in year 2, not £0!. I think that the best solution is to say that where relevant income is distributed, no further deduction is allowed at Step 5, so there is no double deduction. Though this is reading a good deal into the provision.

19.11.6 *Section 733 computation where s.731 remittance basis applies*

Where the s.731 remittance basis[50] applies, s.731 deemed income is still treated as accruing to the foreign domiciled individual under s.731, even though not remitted. So the s.731 remittance basis does not prevent a deduction under Step 2 (and Step 5(a)) if applicable.

Suppose the facts of example 1 or 3 above, but the benefit which B received in year 1 was an unremitted foreign benefit which qualified for the s.731 remittance basis. The computations are exactly the same. Thus benefits to B within the s.731 remittance basis reduce available relevant income in relation to B (whether or not made out of relevant income) just as where the arising basis applies.

Suppose the facts are as in example 2 above, but the benefit which B received in year 1 was a foreign benefit which qualified for the s.731 remittance basis. There is as before no deduction under Step 2 or Step 5, but C must fall back on the two pre-ITA solutions to the RI multiple counting problem:

(1) that distributed income ceases be relevant income (because it ceases to be available); or (if relevant income is not distributed):
(2) Step 5(b): double counting relief.

Solution (2) depends on HMRC discretion, but it is considered that the relief ought to apply to relieve C. Of course, B may not agree. Suppose a

50 See 19.33 (Section 731 remittance basis).

variant of example 2:

Example 4: two beneficiaries (one taxed on remittance basis)

Suppose a trust with Total Relevant Income of £200 and:

(1) Year 1: B receives a benefit (£100) and £100 deemed income under s.731. B is a remittance basis taxpayer and does not remit the benefit so no tax is due.
(2) Year 2: C receives a benefit (£200).
(3) Year 3: B receives the benefit in the UK.

The computation for C in year 2 is the same as example 2:
Step 1: The Total Benefits of C are £200.
Step 2: The Total Untaxed Benefits of C are £200 (nothing is deducted).
Step 5: Total Available Income = £200: There is no deduction from the Total Relevant Income under Step 5(a) because nothing is deducted at Step 2.

Is C taxed on £200? C must fall back on one of the two pre-ITA solutions identified by the tax law rewrite team:

(1) that distributed income ceases be relevant income (because it ceases to be available); so the amount of relevant income is only £100 (assuming B's benefit is a distribution of relevant income); or (if relevant income is not distributed):
(2) Step 5(b): double counting relief.

If the distribution to B did not consist of relevant income solution (2) is the only one available. It depends on HMRC discretion but it is considered that it ought to be allowed. It follows that C will be taxed in year 3. C may argue that B ought to be taxed and his remittance should be tax free, but that seems less "just and reasonable".

19.11.7 *Step 6: computation of charge*

We have at last reached the end of the s.733 computation. Step 6 is as follows:

> Compare the total untaxed benefits and the available relevant income. The amount of the income treated as arising under section 732(2) for any tax year is the total untaxed benefits unless the available relevant income is lower.
> If the available relevant income is lower, it is the amount of income treated as so arising.

That is, the deemed s.731 income is the lesser of:

(1) Total Untaxed Benefits; and
(2) Available Relevant Income.

19.11.8 *Section 733 computation: commentary*

The reader who has labouriously followed the text to this point will agree with the author that s.733 needs to be rethought and rewritten.

19.12 Section 733 computation when benefit subject to CGT

Section 734 ITA provides:

> **Reduction in amount charged: previous capital gains tax charge**
> (1) This section applies if—
> (a) benefits provided as mentioned in section 732(1)(c) are received in a tax year,

That is, the benefit is in principle taxable under s.731.

> (b) for that tax year the whole or part of any benefits so provided is a capital payment to which section 87 or 89(2) of, or para 8 of Schedule 4C to, TCGA 1992 applies (chargeable gains: gains attributed to beneficiaries),

That is, the benefit is in principle taxable under s.87.

> (c) it is such a payment because the total untaxed benefits[51] exceed the

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51 Section 743(4) provides:
"In this section 'the total untaxed benefits' and 'the available relevant income' have the same meaning as in section 733(1) (see Steps 2 and 5)."

> available relevant income (see Step 6 in section 733(1)) and so it is not treated as income arising to the individual under section 732(2), and

That is, the benefit was not subject to income tax for lack of relevant income.

> (d) because of that capital payment chargeable gains are treated as accruing to the individual in that or a subsequent tax year under any of the provisions referred to in para (b).

The CGT charge applies under the rules set out in 19.10 (Is a benefit within s.731 a capital payment?).

> (2) For any tax year after one in which such chargeable gains are so treated, the amount of income treated as arising to the individual under section 732(2) in respect of benefits provided as mentioned in section 732(1)(c) as a result of the transfer or operations in question is calculated as follows.
> (3) The amount is calculated under section 733(1) as if the total untaxed benefits were reduced by the amount of those gains.

This ensures that a benefit charged under s.87 is not later also charged to IT.

19.13 "Relevant income": definition

"Relevant income" is a central but perplexing concept. The absence of litigation on the subject is because HMRC have in practice generally applied the legislation in a way which leads to a sensible result. Section 733(1) Step 3 provides the definition:

> *Step 3*
> Identify the amount of any income which—
> (a) arises in the tax year to a person abroad, and
> (b) as a result of the relevant transfer or associated operations can be used directly or indirectly for providing a benefit for the individual.
> That amount is "the relevant income of the tax year" in relation to the

individual and the tax year.

The condition in Step 3(a), income arising to a person abroad, is the same as in the transfer of asset conditions.[52]

The term is not "relevant income" (in isolation). It is relevant income *in relation to an individual*. There may be relevant income in relation to A which is not relevant income in relation to B (e.g. income of a discretionary trust under which A can benefit and B cannot). There may be relevant income in relation to anyone in the world (e.g. income of a discretionary trust with a power to benefit anyone in the world). In this book I sometimes refer just to "relevant income" and leave the words "in relation to the individual" to be understood. One should only take that shortcut where the context is clear.

The s.731 concept "relevant income" must not be confused with "relevant foreign income."

Although the statute refers to "income" capital receipts are sometimes treated as income for tax purposes.[53]

19.14 Stock dividends

Suppose non-resident trustees receive a stock dividend from a UK company. In that case "income is *treated* as arising to the trustees": see s.410(3) ITTOIA. The amount is certainly "income" for TAA purposes, but the better view is that it is not relevant income. The amount is fictional so one cannot say that it "can" be used for the benefit of any beneficiaries. The shares issued in the stock dividend can be used for that purpose, but they are not the same income. The distinction between a gain and an amount equal to the gain is one on which HMRC insist in a DTT context;[54] here the distinction between the actual stock dividend and the fictional income is similar but clearer.[55]

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52 See 17.5 (Income "becomes payable" to person abroad).

53 See:
(1) 17.13 (Capital receipts deemed to be income).
(2) 22.6.2 (Non-resident company or institution).
(3) 23.14 (OIG accruing to non-resident trust).

54 See 41.6.2 (Distinction between income and sum equivalent to income).

55 The same point arises for AIS income; see 25.14.2 (s.731 ITA).

19.15 Is income of life tenant relevant income?

Consider an interest in possession trust: one where the trust income is payable to a beneficiary ("L").

If L is UK domiciled and resident, the trust income is not relevant income because it does not meet the condition in Step 3(a). It does not arise to a person abroad.

If L is not UK domiciled then the condition in Step 3(a) is satisfied. Nevertheless, the trust income is not relevant income because it is distributed.[56]

There is nothing surprising in this conclusion: there is no need for s.731 in these circumstances, and one would not expect it to apply. If it did apply there could be double taxation – L being taxed on the income he receives, and on other benefits (if he receives any) to the value of the relevant income.

19.16 Is trust income within s.624 ITTOIA relevant income?

One must consider UK resident and domiciled settlors separately from those who are non-resident or domiciled.

19.16.1 *UK resident and domiciled settlor*

Suppose:

(1) a non-resident discretionary trust within s.731;
(2) a UK resident and domiciled settlor ("S") has an interest in the trust.

All the trust income is accordingly within the scope of s.624 ITTOIA. Section 624 ITTOIA provides in such a case:

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56 See 19.21 (Relevant income of trust distributed as income in year it arises). Even if that were wrong:

(1) The trust income is not relevant income in relation to L. One would not say in ordinary language that the trust income *can* be used for providing a benefit for L. The income *is* the property of L.

(2) The trust income is not relevant income in relation to any other person. Since the income belongs to L, one cannot say that the income "can" be used to benefit anyone else. See 19.18 (Income which "can" be used to benefit another person).

> Income which arises under a settlement is treated for income tax purposes as the income of the settlor *and of the settlor alone ...* (Emphasis added)

The trust income is not relevant income as it does not meet the condition in Step 3(a): the income is treated by s.624 as accruing to S, so it cannot be regarded as arising to a person abroad. This is so even if S (wrongly) fails to pay the tax due on the income.

19.16.2 *UK resident foreign domiciled settlor*

Now suppose:

(1) a non-resident discretionary trust within s.731;
(2) a UK resident but not UK domiciled settlor ("S") has an interest in the trust; and
(3) the trust income is actually subject to tax under s.624 ITTOIA (the s.624 remittance basis does not apply).[57]

In this case the condition in Step 3(a) is satisfied since even applying s.624 the income is treated as accruing to S. However, it is considered that the condition in Step 3(b) is not satisfied: if the income is treated as that of S, and of no other person, it is not income which "can be used for providing a benefit" for anybody else. So the income is not relevant income.

The position is different if and to the extent that the s.624 foreign domicile defence applies. Section 624 does not apply to income which qualifies for the s.624 remittance basis.[58] Accordingly the trust income can, in principle, be relevant income for s.731.

What happens then if the income is later remitted, so it becomes taxable on S under s.624? It is tentatively suggested that the income retrospectively ceases to be relevant income, so that tax paid under s.731 can be recovered by a beneficiary. In practice this could arise only in fairly unusual circumstances, e.g. where:

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57 This may be because there is UK source income, or foreign income if received in the UK or S does not claim the remittance basis. See 16.5 (Section 624 remittance basis).

58 See 16.5 (Section 624 foreign domicile defence).

(1) Year 1
(a): a beneficiary ("B") receives a benefit;

(b) foreign source income arises on which the settlor ("S") is not subject to tax as the s.624 remittance basis applies. This is relevant income in relation to B, so B pays tax under s.731.
(2) Year 2: that income is remitted to the UK, so S pays tax under s.624.

Where s.720 applies (as well as s.624) see 19.17 (Is income within s.720 relevant income?).

19.16.3 *Non-resident settlor*

Suppose now:

(1) a non-resident discretionary trust within s.731; and
(2) a non-resident settlor ("S") has an interest in the trust.

Section 624 does not apply to foreign source trust income.[59] Accordingly foreign source income may in principle be relevant income.

Section 624 does apply to UK source income. Here too it is submitted that the condition in Step 3(b) is not satisfied: if the income is treated as that of S, and of no other person, it is not income which "can be used for providing a benefit" for anybody else. So the income is not relevant income.

19.17 Is income within s.720 relevant income?

The analysis is different if income falls within s.720 and not s.624 because the wording of the provisions is entirely different.

HMRC view

ITA EN provides:

59 See 16.9 (Section 624 non-residence defence to s.648).

> Where a non-UK domiciled individual transfers assets but is not chargeable to tax under section 739 ICTA [now s.720 ITA] owing to section 743(3) ICTA [now replaced by the somewhat different s.735 ITA], there is no bar in HMRC's view on the application of section 740 ICTA [now s.731] to others who did not themselves make the transfer but were beneficiaries of it. HMRC interpret section 732 in the same way.[60]

In HMRC's view the position (as in the s.624 case) depends on whether the s.720 remittance basis applies:

(1) where the s.720 remittance basis applies, so the transferor is not taxed, the income of the person abroad is relevant income;; but
(2) where the s.720 remittance basis does not apply (so the transferor is taxed under s.720 on an arising basis) the income of the person abroad is not relevant income.

Where the s.720 remittance basis applies (no subsequent remittance)

At first sight, when the application of the s.720 remittance basis applies does not disapply s.720: the transferor receives s.720 deemed income even though not taxed on it, so it cannot be relevant income.

HMRC might respond that the s.720 income is different income from the income of the person abroad, but that view is to be rejected; see 41.9 (DT reliefs: s.720 ITA).

HMRC may however respond that even though the income of the person abroad is deemed to accrue to the transferor, it also accrues to the person abroad. See *R v Dimsey & Allen*.

Where the s.720 remittance basis does not apply

If that is right, the only defence is s.743 ITA (double counting relief).[61] This is surprising, because it is not clear who qualifies for the relief: the transferor or a beneficiary who receives a benefit. But it is difficult to construe the legislation any other way. What happens where the s.720

60 See Change 105 in ITA EN Vol III, annex 1. The same point was made in the same words in RI 201.

61 See 20.6 (Double-counting relief).

remittance applies and there is a subsequent remittance is an interesting question.

19.18 Income which "can" be used to benefit another person

An essential feature of the definition of relevant income in relation to an individual is the condition in Step 3(b) that the income "can be used for providing a benefit" for the individual.

"Can", like most common words, has a variety of meanings, but the meaning here must be:

> Expressing a possible contingency; = May possibly.[62]

One might refer to this as "can contingently".

19.18.1 *Income of individual*

Of course, any income "can" be used for the benefit of any individual in the world if it is received by a beneficial owner who so directs. That contingency must plainly be ignored or the definition does not work.[63]

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62 *Oxford English Dictionary*, 2nd ed. Another meaning of "can" is "to be able; to have the power, ability or capacity". This meaning applies where one says that a *person* "can" do something. This meaning is not applicable here where the subject of "can" is the income. *Income* does not have any power, ability or capacity: only a *person* does. There is a discussion of *can* in Christopher Williams' fine study, *Tradition & Change in Legal English* (Peter Lang, 2005) at 2.8.

63 The issue is not so much the meaning of the word "can": if income is paid to A it is obvious that it "can" (in the "can contingently" sense of the word) be paid to B if A so directs. The better way to put the issue is: which hypothetical contingencies should be taken into account in order to ask the question whether or not income "can" be used for providing a benefit?
The question is similar to the issue which arises for the purposes of the settlement provisions, whether income "may" be used to benefit the settlor "in any circumstances whatsoever". These words do not include the possible circumstance that there may be "a mere voluntary application of income by a beneficiary to the settlor": see *Glyn v IRC* 30 TC 321 at 329. A similar question arose in reverse in *Inglewood v IRC* [1983] STC 133. The question was whether one could say that a beneficiary "will" become entitled to an interest in possession: held that one should ignore the contingency that the beneficiary may not become entitled by virtue of the beneficiary voluntarily assigning the interest to another person.
Another way to reach this conclusion is to say that the income "can" be used to

19.18.2 *Income received by company owned by individual*

Suppose an individual, T, transfers assets to a non-resident company all the shares of which he owns absolutely. Assume the transfer does not qualify for the motive defence. So long as T remains owner of the company:

(1) The income of the company is relevant income in relation to T (though T may qualify for the transferor's s.731 defence).
(2) The income of the company is not relevant income in relation to any other person.

For the position if T later gives the company to a trust, see 18.29 (Is income of a company held by trust relevant income?).

19.18.3 *Income of A&M trust only payable to B on remote contingency*

Now consider this type of Accumulation and Maintenance trust,[64] divided into two sub-funds:

(1) A's sub-fund: income to be applied for the benefit of A or accumulated; capital to be paid to A at the age of 25; if A dies under 25, the share accrues to B's share.
(2) B's sub-fund is held on similar terms: income to be applied for the benefit of B or accumulated; capital to B at 25 with accrual to A if B dies under 25.

Suppose income is accumulated on A's sub-fund. It is relevant income in relation to A. Is it relevant income in relation to B? It is payable to B only on the contingency that A dies under 25. It is suggested that this income is not relevant income in relation to B. One would not, in normal language, say that the income "can" be used to benefit B just because A may die under 25. The contingency is too remote.

If A dies under 25:

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benefit the individual, but not "as a result of the relevant transfer or associated operations" (the application of the income by the beneficial owner not counting as an associated operation).

64 This was quite a common form before the abolition of relief for A&M trusts in 2006.

(1) income of A's sub-fund arising after the death of A is (of course) relevant income in relation to B;
(2) income of A's sub-fund arising before the death of A subsequently becomes relevant income in relation to B if the "timing" issue discussed below is correctly answered.

If this is correct, the concept here is not the same as in s.624 ITTOIA, where the issue is whether income "may become payable" to the settlor *in any circumstances whatsoever*.[65] Applying (as one should) a purposive approach, this is the fair and just result and consistent with the general scheme of s.731. A settlor or transferor has the opportunity to exclude himself completely in a straightforward manner, and is taxed if he fails to do so. A beneficiary (not the settlor/transferor) has no such opportunity. To tax B on income of A's fund (on the facts of the above example) would not be just or fair.[66]

19.18.4 *Income of discretionary trust*

Conversely, consider a common form discretionary trust. In principle, all trust income "can" contingently be used to benefit any beneficiary, if the trustees exercise their discretion, and that is a contingency which naturally should be taken into account. Trust income is relevant income in relation to all beneficiaries.

Suppose, however, the trustees (perhaps guided by a letter of wishes) regard the fund as divided into (say) two shares for separate families. There is (assume) no practical possibility that more than one half of the income will be used for one particular beneficiary. There is a reasonable argument that only one half of the income is relevant income in relation to that beneficiary.

Trustees of a common form discretionary trust have power to benefit anyone in the world. However, in practice the trustees will wish to identify

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65 See Christopher Williams, *op. cit.* p.139; *may* (compared with *can*) "tends to convey a more hypothetical degree of possibility". It is reasonable to assume that the drafter of the transfer of assets provisions did not copy the language of the settlement provisions because he wanted a different result.

66 Some support can be found in the discussion of "can" (albeit in a different context) in *Mandla v Dowell Lee* [1983] 2 AC 548 at 565. A similar unfairness does arise for CGT under s.87 TCGA. However, it is possible to avoid that by transfers to another settlement.

a more limited class, and it is arguable that trust income is not relevant income in relation to other potential beneficiaries.

19.19 When does one ask? – the timing issue

One must ask whether income "can" be applied for the benefit of an individual. *At what moment in time does one ask this question?*

(1) It often happens that, at the moment it arises, income can be used to provide a benefit for a person, B, but at a later point in time it cannot be so used; for instance if income of a discretionary trust is:
  (a) distributed to another individual (not B);
  (b) transferred to another trust (under which B cannot benefit); or
  (c) retained by the trustees, but on terms under which B cannot benefit; or
  (d) used to pay trust expenses.
(2) The converse also sometimes happens: at the moment it arises income cannot be used to provide a benefit for B, but at a later time it can be so used; for instance:
  (a) if B is born after the income arises;
  (b) if one share of a trust fund later accrues to another share (e.g. on the death of a beneficiary);[67] or
  (c) (arguably) where a company within s.731, wholly owned by A, which has accumulated income during A's ownership, is later given to B or to a trust under which B can benefit.[68]

So it is often important to ask at what moment in time one puts the question. I refer to this as "the timing issue". There are in principle several possible answers:

(1) the moment that the income arises;
(2) the moment that the benefit is provided, if later than (1);
(3) after a "reasonable" period (whatever that might be);
(4) the end of the tax year in which either (1) or (2) or (3) occurs;
(5) the earlier or later of some combination of the above.

67 See 19.18.3 (Income only payable to B on remote contingency).
68 See 18.29 (Is income of company held by trust relevant income?).

An important consequence of all solutions except (1) is that trustees of a discretionary trust or company within s.731 would usually have some period of time after income has accrued, during which they may:

(1) distribute income; or
(2) apply the income in the payment of expenses.

Then the income will not be relevant income in relation to the beneficiaries because *at the moment when one asks the question* it is no longer income which "can" be applied for the benefit of the beneficiaries.

To answer the question we must return to the legislation. Section 733 ITA Steps (3) and (4) provide:

> *Step 3*
> Identify the amount of any income which—
> (a) arises in the tax year to a person abroad, and
> (b) as a result of the relevant transfer or associated operations can be used directly or indirectly for providing a benefit for the individual.
> That amount is "the relevant income of the tax year" in relation to the individual and the tax year.
> *Step 4*
> Add together the relevant income of the tax year and the relevant income of earlier tax years in relation to the individual (identified as mentioned in Step 3).
> The sum of those amounts is "total relevant income".

Steps 3 and 4 taken together can be read in various ways:

> *Step 4*
> Add together
> [1] the relevant income of the tax year *being the amount of any income which—*
> *(a) arises in the tax year to a person abroad, and*
> *(b) as a result of the relevant transfer or associated operations can be used directly or indirectly for providing a benefit for the individual.*
> and
> [2] the relevant income of earlier tax years in relation to the individual *being the amount of any income which—*
> *(a) arises in the [<u>earlier</u>] tax year to a person abroad, and*
> *(b) as a result of the relevant transfer or associated operations can*

[i] *[at any time in that earlier year]* **or**
[ii] *[at the end of the earlier year]* **or**
[iii] *[at the time that the benefit is conferred, or the time that the income arises if later]*
be used directly or indirectly for providing a benefit for the individual.

(In this quote the words in normal font are the words of Step 4; the words in italics are the words of Step 3; the words underlined are added; note that some words must be added in any event.)

In clause [2][b] readings [i] [ii] [iii] are alternatives. Reading [iii] is best, because:

(1) it makes sense of the words "in relation to the tax year" in Step 3.
(2) is more sensible to ask the question at the time it matters.

So it is considered that one looks to the position at the later of:

(1) the end of the tax year in which the relevant income has accrued, or
(2) the end of the tax year in which the benefit accrues.

One asks whether *at that time* the income:

> can ... be used for providing a benefit for the individual.

Another way to put it is that one asks the question with the benefit of hindsight, taking into account facts known at the time that the question matters. This is the view of the old law taken in this book, but it seems slightly clearer under ITA. It is also supported by ITA EN:

> It is therefore considered that surplus relevant income (*if it continues to be available*) has not been taken into account and so must be carried forward year by year until extinguished by a benefit or benefits.[69]

This approach appears to be accepted by HMRC in practice.

The moment the income arises is not a suitable moment to ask the question. In some cases it is impossible to ascertain the moment at which income arises and all that the tax system attempts is to attribute income to

69 The EN is discussed in 19.11.5 (Step 5: Available Relevant Income).

an accounting period or year of assessment.[70] In other cases it is only possible to ascertain a moment at which income arises by rules of a somewhat arbitrary kind.[71]

There is further support in the legislation for this view. Step 3 does not refer to "relevant income" in isolation. It refers to relevant income *of the tax year in relation to the tax year*. It is obviously necessary to attribute relevant income to a tax year, e.g. to deal with the situation where:

(1) an individual receives a benefit in year 1;
(2) the benefit is not taxed because there is no relevant income in year 1;
(3) relevant income arises in year 2.

There is only relevant income *of year 2* and so the s.731 charge arises in year 2 and not in year 1. However, the reference in Step 3 is to income of the tax year *in relation to the tax year*. These extra words suggest that the relevant income of tax year 2 in tax year 2 may be different from the relevant income of tax year 2 in tax year 3. In year 3 one must ask again what is the relevant income of year 2.[72]

19.20 Relevant income used to pay expenses

HMRC practice is that income used to pay trust or company administration expenses will reduce relevant income. This is consistent with the approach taken above. This applies even to income used for capital expenditure of a trust. This is confirmed by (or at least consistent with) two HMRC statements. Firstly income used to meet a statutory indemnity ceases to be relevant income (even a CGT indemnity, i.e. a capital liability):

> **CIOT Letter (extract)**
> It would also be helpful if the Revenue could confirm that if the trustees do in fact make a payment to the settlor in response to a request for reimbursement, either under [s.646 ITTOIA] or under para 6 of Schedule 5 to TCGA, such a payment would not be regarded as: ...
> (b) Taken into account for [s.731 ITA] purposes;

70 e.g. trading or property income.
71 e.g. the rules in ss.18–19 ITEPA (When general earnings are received).
72 I have considered whether any guidance is to be found in the principle that income tax is an annual tax. However, that does not shed much light on the problem.

> (c) Income of the settlor for Case V Schedule D [now RFI] purposes.
>
> **The Revenue's reply**
>
> ...
>
> Using your lettering ...
>
> (b) *it will reduce the relevant income if paid out of income* but will not be a payment [ie not a benefit];
>
> (c) confirmed.[73]

Secondly, income used to pay a sum in lien of interest ceased to be relevant income (even though the payment is of a capital nature). Tax Bulletin 8 provides:

> ESC D41 allowed, inter alia, demand loans made to offshore trustees on better than commercial terms before 19 March 1991 to be put on commercial terms after that date. This enabled a trust to remain outside the condition in para 9(3), Schedule 5, TCGA 1992. In order to meet the terms of this concession, it may have been necessary to pay a sum in lieu of interest in respect of periods ended 5 April 1992. Where this was the case, such a payment would not have any IHT implications and it would qualify as a deduction both in determining the income of the life tenant *and for the purposes of [s.731 ITA] provided it was paid out of trust income*.
>
> Where the amount in lieu of interest was paid to a person who is not a beneficiary under the terms of the trust, it would nevertheless be treated as a capital payment to that individual under TCGA 1992, Section 97. If the amount in lieu of interest was paid by a company underlying the trust, that payment would not qualify for a deduction from the profits of that company.

Thus income used to pay interest ceases to be relevant income. Income used to repay borrowed capital also ceases to be relevant income; though if this principle was applied to extremes in a tax avoidance scheme, the sum borrowed might be regarded as representing the relevant income: see 19.26 (Relevant income reinvested: trading).

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73 *Taxation Practitioner*, April 1996 p.25 accessible *www.kessler.co.uk*, emphasis added. For other issues relating to reimbursement see 58.21 (Failure to exercise right of reimbursement). See too 19.4.10 (Reimbursement of tax under statutory indemnity).

19.21 Relevant income of trust distributed as income in year it arises

Suppose income ("the trust income") accrues to trustees of a discretionary trust within s.731, and is distributed (as income) to a beneficiary, "B1", in the same tax year.

19.21.1 *Position of other beneficiaries*

The trust income is not relevant income in relation to any other beneficiary, since the income was distributed to B1. One cannot say that the income "can" be applied for the benefit of anyone else – if the author's answer to the timing issue is correct. This is significant for the other beneficiaries who receive a benefit within s.731 (whether before or after the year in which the income arises and is distributed). They will not pay tax on the benefit by reference to the distributed income, because it is not relevant income. (They may pay tax on the benefit by reference to other relevant income if there is any.)

That must be correct, because otherwise there could be double taxation (B1 taxed on his trust income and another beneficiary taxed under s.731).[74]

19.21.2 *Position of recipient beneficiary*

It is suggested that the income is not relevant income in relation to B1: it is not income which *can* be used for his benefit; it is income which *is* used for his benefit.[75] This is significant for B1 if:

(1) B1 is UK resident but not domiciled, and
(2) B1 received a benefit in the UK, and
(3) the trust income is paid to B1 and not remitted to the UK.

B1 is taxed on the remittance basis on the income he receives from the trust. He is not taxed on the benefit by reference to the distributed income, because it is not relevant income. (B1 may pay tax on the benefit by reference to other relevant income if there is any.)

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74 Arguably s.743 ITA would provide relief: see 20.6 (Double-counting relief). But this is not a satisfactorily solution as it is not clear who pays the tax.

75 The same argument as 19.15 (Is income of life tenant relevant income?) but not so strong.

19.22 Relevant income of trust distributed as income after year it arises

Suppose income accrues to trustees of a discretionary trust, within s.731, and is retained (without being accumulated) in that tax year, but is distributed (as income) to beneficiary B1 in a subsequent year. If:

(1) a UK resident beneficiary ("B2") had received benefits in the past, and
(2) had not paid tax under s.731, for lack of relevant income,

B2 will pay tax under s.731 in the year in which the income arises.

Suppose, however, that there have been no earlier benefits so this is not in point. The position is then the same as in the above paragraph, if the author's answer to the timing issue is correct:

(1) The income is not relevant income of B1.
(2) The income is not relevant income of any other beneficiary.

19.23 Relevant income of trust accumulated

19.23.1 *Income accumulated and retained on wide discretionary trusts*

If trustees of a common form discretionary trust accumulate income, it remains relevant income in relation to all beneficiaries as long as it is retained by the trustees because the trust capital (which represents the accumulated income) can be used to benefit any beneficiaries.

19.23.2 *Income accumulated and retained on narrower trusts*

The position would be different if under the terms of the trust:

(1) B was in the class of beneficiaries to whom income could be paid; but
(2) B could not benefit in any way from income after it had been accumulated.

Accumulated income would cease to be relevant income in relation to B. This may happen automatically, e.g. a formerly common form of accumulation and maintenance trust provided:

(1) Income may be used for the benefit of any beneficiary under 25 ("B1", "B2" or "B3").
(2) If not so used, it is accumulated and added to the share of one particular beneficiary (B1) and can only be used for the benefit of B1 (not B2 or B3).

On receipt the income is relevant income in relation to B1, B2 and B3. After accumulation it is relevant income only in relation to B1.

A similar point arises in relation to a common form discretionary trust. Accumulated income is relevant income in relation to all the beneficiaries. Suppose the trustees exercise their overriding power to exclude B from the accumulated income, not from other trust capital. The income ceases to be relevant income in relation to B. It makes no difference whether this is done in the year of receipt or later.

Similar points arise if the income is transferred to a new trust, or if the income of a company within s.731 is capitalised by the issue of bonus shares.

19.23.3 *Income accumulated but later distributed as income*

It has been suggested that once income is accumulated, it is forever relevant income in relation to all the beneficiaries to whom it could have been paid. Subsequent distribution is irrelevant (unless it gives rise to a s.731 charge). This view gives rise to anomalies:

(1) Some receipts which are capital for trust law purposes are treated as income for s.731,[76] and these cannot be "accumulated" in the normal trust sense. It would be odd if they were treated differently from ordinary income for s.731 purposes.
(2) Income of a company within s.731 cannot be "accumulated" in the trust sense. It would be odd if companies were treated differently from trusts.

For my part I do not see why the process of accumulation should by itself make any difference to the s.731 position. If income of a common form

76 See 17.13 (Capital receipts deemed to be income).

discretionary trust is accumulated, and later distributed as income to B1, it ceases to be relevant income in relation to other beneficiaries. This only applies if the sum distributed is (or represents) the accumulated relevant income. This raises tracing issues discussed below.

19.23.4 *Income accumulated and distributed as capital*

Suppose income of a common form discretionary trust is accumulated and distributed as capital to a beneficiary, B. It is considered that the income ceases to be relevant income in relation to any beneficiary except B. (It is relevant income in relation to B so that B is in principle subject to tax under s.731 if he is ordinarily resident in the UK. Any other conclusion would be absurd.)

A capital distribution out of accumulated relevant income to a UK resident individual is taxable under s.731. It does not reduce s.87 trust gains. However the same payment to a charity or a non-resident individual will reduce trust gains and relevant income.

19.24 Corporate income distributed to trust

Suppose a company within s.731 is held by a common form discretionary trust within s.731:

(1) the company receives income ("**corporate income**");
(2) the corporate income is distributed by way of dividend and retained by the trustees.

Thus:

```
   Trust                 Dividend
     |                      ↑
 [Company]          Corporate income
     |                      ↑
   Assets
```

The corporate income ceases to be relevant income so it is not counted twice. For one cannot say that the corporate income and the dividend income are *both* available to provide a benefit.[77]

Suppose:

(1) a company within s.731 is held by a common form discretionary trust;
(2) the company's income is distributed by way of liquidation and retained by the trustees.

Double counting relief does not apply. It is suggested that the trustees receipt represents the relevant income, so the liquidation does not affect the s.731 position. (Any other view would allow tax avoidance and not be attractive to a court.)

19.25 Distributed income: HMRC view

RI 201 states:

> For the purposes of Section 740(3) ICTA [now s.733 ITA] the measure of "relevant income" is treated as not including such part of the income as has already been genuinely paid away to a beneficiary or to a bona fide charity.
> Once relevant income has arisen *and continues to be available to provide a benefit*, it must in the Revenue's view be carried forward year by year until extinguished by such a benefit, even if it is capitalised in the accounts of the overseas person.
>
> (Emphasis added)

This does not address all the permutations set out above, but it seems to be more consistent with the above than with any other interpretation.

19.26 Relevant income reinvested: tracing

The requirement is that "income" can be used to provide a benefit. However, "income" here includes any asset representing income, even if that asset does not constitute "income" (in any sense) of the person

77 Even if that were wrong, it is suggested that double counting relief prevents the corporate income and the dividend income from counting as relevant income; see 20.10 (Section 731 trust/company structure).

abroad.[78] Thus it makes no difference if the relevant income is invested in another asset.

Suppose:

(1) A non-resident company held by a trust has received relevant income ("**the corporate relevant income**").
(2) The trustees sell the company to a purchaser.

It has been suggested that the corporate relevant income ceases to be relevant income in relation to the beneficiaries, because (after the sale) that income can no longer be used to benefit them. That would be absurd, but there is no difficulty in construing the legislation to avoid that absurdity. The proceeds of sale represent the corporate relevant income, so the sale has not affected the relevant income position at all: as long as those proceeds can still be used for the benefit of the beneficiaries there is still relevant income in relation to the beneficiaries.

19.27 Tracing: are distributions out of relevant income?

The principle that distributed income ceases to be relevant income applies only if the asset distributed constitutes the relevant income. Whether or not this is the case raises questions of tracing. The safest approach is for a trust or company within s.731 to keep trust income in a separate account so funds distributed can easily be identified as relevant income. But if we must enter this unchartered territory, it is suggested that the case law on pre-2008 remittance basis tracing principles provides helpful guidance.

19.27.1 *Cash distribution from trust within s.731*

Suppose:

(1) Trustees of a discretionary trust within s.731 receive relevant income and pay it to a mixed account (i.e. holding income and trust capital together).

78 Similar principles apply for the RFI remittance basis. See 9.3.5 (Capital/income terminology in remittance basis context) example (4). A similar principle applies in ascertaining what is income for the definition of power to enjoy; see 18.6.4 (Employment Condition D: possibility of benefit).

(2) They pay a sum out of that account in exercise of a power over trust income.

It is considered that the sum distributed would be (or represent) the relevant income.

Suppose:

(1) The trustees receive relevant income, accumulate it and pay it into a mixed account (i.e. holding accumulated income and trust capital together).
(2) They pay a sum out of that account in exercise of a power to apply accumulated income as income.

It is suggested that the sum distributed would be (or represent) the relevant income.

Suppose:

(1) The trustees receive relevant income, accumulate it and pay it into a mixed account (i.e. holding accumulated income and trust capital together).
(2) They pay a sum out of that account in exercise of a power to distribute capital.

It is suggested that the trustees could by appropriate documentation identify the sum distributed as the relevant income.[79] Otherwise there must be an apportionment.

19.27.2 *Cash distribution from company within s.731*

Suppose:

(1) A company within s.731 receives relevant income and pays it to a mixed account (i.e. holding relevant income, capital profits and other company funds together).
(2) The company declares a dividend.

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79 See 9.33 (Remittance from mixture of taxed and untaxed income).

In the absence of documentation, it is arguable that income comes first out of a mixed fund: the alternative view is that the dividend represents the company's distributable profits *pro rata*. If the company has only received income (i.e. has not realised capital gains), the dividend represents that income.

Suppose:

(1) A company within s.731 receives relevant income and pays it to a mixed account (i.e. holding relevant income and other company funds together).
(2) The company repays a loan out of that account.

It is tentatively suggested that the company would by appropriate documentation earmark the sum repaid as the relevant income. In that case the trustees could distribute it and it ceases to be relevant income.

19.27.3 *Distribution of company*

Suppose a non-resident company held by a trust has received relevant income ("**the corporate relevant income**"). If the trust transfers the company to an individual, the corporate relevant income ceases to be relevant to beneficiaries (except the individual). If the trust transfers the company to a new trust, the corporate relevant income is relevant income in relation to the beneficiaries of the new trust but not in relation to beneficiaries of the old trust who cannot benefit under the new trust. This is a sensible rule as it allows different branches of a family to separate their interests fairly.

19.28 Distributing income: tax planning

A common strategy is:

(1) distribute all income (from a discretionary trust or underlying company within s.731) to a foreign domiciled settlor;
(2) the settlor may re-settle the income on the same trusts.

This avoids relevant income in the trust or company.[80] It would be better to have an interest in possession trust so income at the trust level will be distributed automatically. Watch *Furniss v Dawson*: it is best to avoid provocative circularity.

A variant of this idea is to distribute income to a beneficiary who is not the settlor/transferor, but who is non-resident (or domiciled) and so outside s.731. Watch *Furniss v Dawson* here.

19.29 Is income of company held by a trust relevant income?

19.29.1 *Income accruing while company held by trust*

Suppose a trust with a common form power of appointment holds a trust subsidiary company to which s.731 applies.[81] Income of the company is in principle relevant income in relation to all beneficiaries. It remains so as long as the company retains the income.

19.29.2 *Income accruing before company is acquired by trust*

Suppose:

(1) An individual ("T") owns all the shares of a company within s.731.
(2) T gives the shares to a trust with a common form power of appointment.

Income of the company arising after the gift of T is in principle relevant income in relation to the beneficiaries of the trust.

What is the status of income arising before the gift ("old income")? HMRC say that old income is also relevant income in relation to all the beneficiaries. HMRC's argument is simple: at the relevant time (when benefits are received) the old income "can" be used for the benefit of beneficiaries. The tax consequences of this are so severe that one feels it cannot be right, but what is the flaw in the argument?

At the time when the old income accrued to the company, that income

80 Also (if relevant) this ensures that the settlor receives the benefit of distribution relief; see 20.4 (Distribution relief).

81 In practice the motive defence may apply to the transfer to the company; see 21.31 (Transfer of UK assets from non-resident trustees to non-resident trust subsidiary).

"can" *only* be used to benefit T, the sole shareholder, so it is not relevant income in relation to anyone else. After the company has been given to the trust the same income "can" be used to benefit others. That is sufficient to meet the "can" condition, if the author's answer on the timing issue is correct.

However, it is not enough that income "can" be used to benefit a person. The definition of "relevant income" requires that the income can be used to benefit an individual:

> as a result of
> (i) the relevant transfer or
> (ii) associated operations.[82]

I refer to this as "**relevant income causation conditions (i) and (ii)**".

Now, in this case there are two transfers:

(1) The transfer of assets to the company ("transfer 1").
(2) The transfer of the shares in the company to the trust (an associated operation) ("transfer 2").

It is tentatively suggested that where the two transfers are not part of a single arrangement, but entirely independent. Transfer 2 is not an associated operation in relation to transfer 1. So relevant income causation condition (ii) is not satisfied. Relevant income causation condition (i) is not satisfied since transfer 1 is not the cause of the fact that the income can be used to benefit the beneficiaries. The reasoning is the same as 17.11.1 (Transfer from A to B followed by transfer from B to person abroad).

19.30 Individual not a beneficiary when income arises

19.30.1 *Beneficiary unborn when income arises*

Suppose:

(1) In Year 1 a discretionary trust within s.731 receives and accumulates relevant income.
(2) In Year 2 a beneficiary is born.

82 The reference here is to the reference to associated operations in s.732(1)(c).

Is the income accumulated in year 1 before the birth relevant income in relation to that beneficiary? Robert Venables QC supports the view that it is not.[83] The answer depends on the timing issue. If the author's view is right, undistributed income accumulated before birth can be relevant income in relation to the newborn beneficiary, and that view does make more sense, having regard to the general scheme of the legislation.

19.30.2 *Individual in existence but not a beneficiary when income arises*

Suppose:

(1) In Year 1 a discretionary trust within s.731 receives and accumulates relevant income. The class of beneficiaries consists of the issue of the settlor and their spouses.
(2) In Year 2 an individual ("W") marries a beneficiary and so joins the class of beneficiaries.[84]

Is the income accumulated in year 1 before the marriage relevant income in relation to W? The answer depends again on the timing issue. If the author's view is right, undistributed income accumulated before the marriage can be relevant income in relation to W. Those who take the view that pre-birth income is not relevant income might consistently take the view that this pre-marriage income is not relevant income. This is not quite a *reductio ad absurdum*, but it is surely a bold view. If necessary, a court would hold that W "can" benefit in year 1 because of the possibility that W may marry a beneficiary in year 2. See *IRC v Tennant* 24 TC 215. But this contingency may be very remote, so the author's preferred analysis is less artificial.

19.30.3 *Beneficiary dead when income arises*

Now suppose the opposite situation:

83 *Non-Resident Trusts*, 8th ed., para 2.6.5 (Can one avoid the "relevant income" anti-avoidance provisions?).

84 It is assumed there is no power to add beneficiaries so the income could not be applied for the benefit of the individual before the marriage.

(1) Year 1: a beneficiary receives a benefit from a trust (which is not taxable for lack of relevant income).
(2) Year 2: the beneficiary dies.
(3) Year 3: relevant income accrues.

Here it is plain that there is no tax charge on the beneficiary. Income cannot be deemed to have accrued to him once he is dead.

The same applies in relation to income which accrues in the tax year of death, but after the death. One cannot say that income accruing after the death of a person "can" be applied for his benefit.

19.30.4 *Individual excluded from benefit*

Income arising after a former beneficiary is excluded from benefit cannot (on any view) be relevant income in relation to that beneficiary. It is not necessary that the beneficiary should be excluded from benefit altogether: just that he is excluded from benefit from the income.

19.31 Transfers between trusts

Section 90 TCGA provides a code dealing with transfers between settlements for the purposes of s.87 TCGA.[85] This is needed because a s.2(2) amount is computed in relation to settlements. Each settlement has a s.2(2) amount attributed to it.

Section 731 by contrast has no such need. Relevant income is *not* computed in relation to settlements. It is computed in relation to individuals. Thus a transfer of relevant income from trust 1 to trust 2 does not reduce the relevant income if the beneficiaries of trust 1 and trust 2 are the same.

19.32 Tax and tax credits of person abroad

This topic is not difficult to understand – at least it does not seem difficult once one has understood it. But it is impossible to summarise briefly. One must bear in mind three separate concepts:

85 See 38.17 (Transfers between trusts).

(1) The actual income of the person abroad.
(2) Relevant income for s.731.
(3) The income which is deemed under s.731 to accrue to the UK resident individual who receives a benefit ("s.731 deemed income").

These must not be confused! The *actual income* of the person abroad is taxed (if at all) under general principles.

Relevant income is not taxed as such: it is merely something computed as a part of the process of ascertaining the amount of s.731 deemed income.

Section 731 deemed income is taxed at the lower/basic/higher rates. In practice an individual's s.731 deemed income is likely to be taxed at the higher rate, 40%.

This section considers the complications which arise if the actual income of the person abroad is subject to UK tax or foreign tax. How does this affect the s.731 deemed income? It is necessary to consider separately the position where the person abroad is:

(1) A discretionary trust.
(2) Any trust, on the purchase of own shares.
(3) A company owned by an individual.
(4) A company owned by a non-resident trust.

19.32.1 *Tax and tax credits of non-resident discretionary trust within s.731*

A non-resident discretionary trust will normally pay tax on its actual UK source income at the rate applicable to trusts. The amount of tax paid reduces the relevant income so that if the gross income is £100 and tax is 40%, the relevant income is reduced to £60. However, s.731 makes no further allowance for a beneficiary. So if a beneficiary receives a benefit of £60, taxable under s.731, he pays tax at the rate of 40% on the £60. The effective rate of tax on the actual income of the person abroad is therefore 64%. Section 743 ITA probably does not help. It would be much better if the beneficiary received an income receipt from the trust.[86] Then s.731 would not apply[87] and instead the beneficiary will effectively obtain some

86 As to how to achieve this, see 11.18 (Payment from discretionary trust: income or capital?).
87 See 19.9 (Benefit liable to IT defence).

credit for the UK tax paid by the offshore trust under the regime of Chapter 7 Part 9 ITA.[88]

The same point applies where the income accruing to the offshore trustees is subject to foreign tax which can qualify for double taxation relief in the UK under ESC B18. It is best to arrange that the income is received by a UK resident beneficiary in the form of income, avoiding s.731 deemed income where the possibility of any double taxation relief is lost.

An IP trust is better still for dividend income.

These are harsh rules, but the unfairness of s.731 may be avoidable in practice and any other rule would certainly be extremely complicated to draft and to administer.

19.32.2 *Purchase of own shares*

The receipt on a purchase of own shares by a UK company is income.

Any trust, discretionary or IP, is subject to additional rate tax on a purchase of own shares. This raises the same tax problems as a discretionary trust under ss.481, 482 ITA. One solution is to alter the terms of the trust before the purchase, so the proceeds of sale belong to the life tenant. Another solution may be to make the trust UK resident for income tax purposes.

19.32.3 *Tax and tax credits of non-resident company within s.731*

A non-resident company will normally pay tax on its actual UK source income at the basic rate. The amount of tax paid reduces the relevant income so that if the gross UK source income is £100 and tax is 20%, the relevant income is reduced to £80. Once again, s.731 makes no further allowances. So if an individual receives a benefit of £80, on which he is taxed under s.731, he pays tax at the rate of 40% on the £80. The effective rate of tax on the actual income of the person abroad is therefore nearly 52%.

A similar point arises in relation to dividend income, which is not taxable in the hands of the company.

It would be slightly more efficient if the beneficiary received a dividend from the company. Then s.731 would not apply. The individual would

88 Unfortunately the credit is less than full credit in the case of dividend income. The regime is too complex to set out here.

still not receive any credit for the tax paid by the offshore company but his dividend income would at least be taxed at the slightly lower dividend upper rate of 32.5%.

19.32.4 *Tax planning by means of UK resident company*

Further tax planning is to make the company UK resident (or to acquire a UK resident company). Then the actual income of the company is paid out by way of dividend (assuming this is possible as a matter of company law) and taxed at the dividend upper rate with the benefit of the UK tax credit. Watch s.490(4) ICTA. The effective rate of tax is reduced to 25%.

The reduction in the maximum rate of CGT from an effective penal rate of 64% to 28.8% has removed the motivation for this kind of planning.

This has been the position since the current absurd dividend rules took effect in 1999. The result can hardly have been foreseen by the Government when the rules were enacted. The rules have not, however, been changed since. One would like to think that this was a pragmatic policy decision by the Government. For under this planning HMRC does obtain *some* tax, whereas if the (by modern standards, penal) 64% CGT rate were applicable, then trust gains are unlikely to come into charge if at all possible, and everybody is the loser.

19.32.5 *Commentary*

In the 6th edition of this book I said:

> These are harsh rules, but the unfairness of s.731 is generally avoidable in practice and any other rule would certainly be extremely complicated to draft and to administer.

The complexity arises in matching s.731 deemed income with the taxable income of the person abroad. But now the FA 2008 has introduced matching rules. (Complexity was not a serious concern to the architects of the 2008 reforms.) What is sauce for the goose is sauce for the gander. If the matching rules must be retained, fairness requires that there should also be a system of credit for tax on the relevant income. (My preference would be for the rough and ready but simpler rules which took effect from 1981 to 2008, but at present we have the worst of both worlds – complexity and unfairness.)

19.33 Section 731 remittance basis

Section 735 ITA[89] provides a relief which I call "**the s.731 remittance basis**". Section 735(1) provides:

> This section applies if—
> (a) income is treated under section 732 as arising to an individual in a tax year ("the deemed income"),
> (b) section 809B, 809D or 809E (remittance basis) applies to the individual for the year, and
> (c) the individual is not domiciled in the UK in the year.

In short, the relief applies to remittance basis taxpayers. Section 735(2) ITA defines the term "foreign deemed income":

> For the purposes of chapter A1 of Part 14 (remittance basis) the deemed income is "foreign" if (and to the extent that) the relevant income to which it relates would be relevant foreign income if it were the individual's.

For the purposes of discussion one must carefully distinguish:

(1) relevant income (in short, income arising to the person abroad); and
(2) income treated under section 732 as arising to an individual (which statute calls "the deemed income" and which I call "**deemed s.731 income**").

Section 735(3) ITA provides the relief:

> Treat the foreign deemed income as relevant foreign income of the individual.

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89 Flagged (somewhat unnecessarily) by s.731(2A) ITA:
"(2A) But see section 735 (non-UK domiciled individuals to whom remittance basis applies)."

This incorporates the RFI remittance basis. It would not work by itself as the deemed income (being fictional) does not exist and cannot be remitted. So s.735(4) ITA provides:

> For the purposes of those sections treat relevant income, or a benefit, that relates to any part of the foreign deemed income as deriving from that part of the foreign deemed income.

This must mean:

> For the purposes of those sections treat
> [a] relevant income *that relates to any part of the foreign deemed income*, or
> [b] a benefit that relates to any part of the foreign deemed income
> as deriving from that part of the foreign deemed income.[90]

In the following discussion:

(1) "**Remittable relevant income**" is relevant income that relates to foreign deemed income.
(2) "**Remittable benefit**" is a benefit that relates to foreign deemed income.

Thus we have three fictions. Firstly we pretend that the individual receives deemed s.731 income. Secondly, we pretend that the deemed income is RFI. Thirdly, we pretend that remittable relevant income *and* remittable benefits derive from that RFI.[91] The third fiction feeds into remittance condition B. If anything derived from the remittable benefit (or the remittable income) is received in the UK by the individual or by a relevant person (in relation to the individual), there is a charge under the remittance basis.

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90 That is, the phrase "that relates to any part of the foreign deemed income" qualifies "relevant income" as well as "benefit".

91 Contrast the solution adopted for the s.87 remittance basis, where the capital payment (corresponding to the remittance benefit) is deemed to derive from the deemed s.87 gains, but the s.2(2) amount (corresponding to remittable relevant income) is not.

19.33.1 *Transitional rules*

Para 170 Sch 7 FA 2008 provides:

> The amendments made by paras 161 to 179 have effect for the tax year 2008-09 and subsequent tax years.

Section 735 does not apply to benefits accruing to a person abroad before 2008/09 because the condition in s.735(1)(b) is not met.

19.34 Relating deemed s.731 income to relevant income and to benefits

The legislation requires one to identify:

(1) (a) the relevant income to which deemed s.731 income relates: s.735(2) ITA;
  (b) relevant income that relates to deemed s.731 income: s.735(4)[a] ITA; and
(2) benefits that relate to deemed s.731 income: s.735(4)[b] ITA.

These concepts are explained in s.735A ITA. This works in four stages.

19.34.1 *Place benefits in due order*

Section 735A(1) ITA provides:

> For the purposes of section 735—
> (a) place the benefits mentioned in Step 1 [benefits within s.731][92] in the order in which they were received by the individual (starting with the earliest benefit received),

Some benefits are not received at any particular moment in time, e.g. the benefit of rent-free accommodation, and it is not possible to place them in the order in which they are received. Perhaps there should be a time apportionment.

One then makes certain deductions from the benefits:

92 Section 735A(2) ITA provides:
"In subsection (1) references to a step are to a step in section 733(1)."

(b) deduct from those benefits so much of any benefit within section 734(1)(b) as gives rise as mentioned in section 734(1)(d) to chargeable gains or offshore income gains.

19.34.2 *Place relevant income in date order*

Section 735A(1) ITA continues:

> (c) place the income mentioned in Step 3 for the tax years mentioned in Step 4 ("the relevant income") in the order determined under subsection (3),

Note that Steps 3 and 4 here refer to the steps in s.733; confusingly the reference is not to the steps in s.735A(3) which immediately follow.
This takes us to s.735A(3) ITA:

> The order referred to in subsection (1)(c) is arrived at by taking the following steps.
> *Step 1*
> Find the relevant income for the earliest tax year (of the tax years referred to in subsection (1)(c)).
> *Step 2*
> Place so much of that income [relevant income] as is not foreign[93] in the order in which it arose (starting with the earliest income to arise).
> *Step 3*
> After that, place so much of that income as is foreign in the order in which it arose (starting with the earliest income to arise).

In order to carry out Steps 2 and 3 it is necessary to distinguish between:

(1) foreign relevant income; and
(2) other relevant income (which I shall call "**UK relevant income**").

Some income is not received at any particular moment in time, e.g. trading and property income, where the income is computed as a net figure after allowing deductions. Section 735A(5) ITA deals with this:

93 Section 735A(5) ITA defines "foreign":
"For the purposes of subsection (3) relevant income is 'foreign; where it would be relevant foreign income if it were the individual's."

> For these purposes to treat income for a period as arising immediately before the end of the period.

TA Remittance Guidance para 1234 provides

> In the event that income arises over a period it is treated for the purpose of this provision as arising immediately before the end of the period. For example, business profits accrue over an accounting period to say 31 December so for the purpose of this provision the income would be treated as arising on 31 December. Therefore if in a tax year there was say interest income arising on 30 September and business profits accruing over an accounting period to 31 December, for the purpose of this provision they would be placed in the order interest first and profits second.

Then one carries out Steps 1–3 for earlier years:

> *Step 4*
> Repeat Steps 1 to 3.
> For this purpose, read references to the relevant income for the earliest tax year as references to the relevant income for the first tax year after the last tax year in relation to which those Steps have been undertaken.

In short, the ordering rules are:
(1) Earlier years before later years.
(2) Within the years, UK income before foreign income.

Why does the legislation not simply say that?

19.34.3 *Deduction from relevant income*

Section 735A(1)(d) ITA provides:

> (d) deduct from that income any income that may not be taken into account because of section 743(1) or (2) (no duplication of charges),

Section 735A(6) ITA provides:

> Subsection (1)(d) does not apply if the income may not be taken into account because the individual has been charged to income tax under section 731 by reason of the income.

19.34.4 *Place s.731 deemed income in date order*

Section 735A(1)(e) provides:

> place the income treated under section 732(2) as arising to the individual in respect of the benefits in the order in which it is treated as arising (starting with the earliest income treated as having arisen),

19.34.5 *Relating income*

Having identified these matters and placed them in date order with appropriate deductions, we can at last turn to the income-related rule itself. Section 735A(1)(f) ITA provides:

> treat the income mentioned in para (e) [deemed s.731 income] as related to—
> (i) the benefits, and
> (ii) the relevant income,
> by matching that income with the benefits and the relevant income (in the orders mentioned in paras (a), (c) and (e)).

In short, one matches income of earlier years before later years and (within years) one matches UK relevant income before foreign relevant income. The rule is arbitrary.

The general principle will be to avoid UK source relevant income if at all possible, since the effective rate of tax on that income may reach 80%.

19.34.6 *HMRC examples*

TA Remittance guidance gives a number of examples, most of which are self-evident, but two are worth setting out here. Para 1234 provides:

Example 10

		Relevant Income		
Year	Date	UK Income	Foreign Income	Benefits
1	30 Sept	500		
1	31 Dec		500	
2	31 Dec		1000	750
3	30 Sept		500	
3	31 Dec	500		
4	30 Sept		500	
4	31 Dec	500		750

There are potential transfer of assets benefits charges in Yr 2 of 750 and Yr 4 of 750. In Yr 2, 250 will be foreign deemed income and ring fenced to be charged under Part 8 ITTOIA as and when there is an amount remitted to the UK. 500 is charged under transfer of assets. In Yr 4 the whole 750 will be deemed foreign income. If however the benefit in Yr 4 was 1500, then only 1250 would be ring fenced as foreign deemed income and 250 would be charged under transfer of assets.

There is a second useful example at para 1236:

Example 11
An individual who is ordinarily resident, but not domiciled, in the United Kingdom has received cash benefits from an offshore structure in circumstances where the conditions for the transfer of assets provisions to apply are met. The 'remittance basis' of taxation applies for each year.

Year	Date arises	UK income	Foreign income	Benefits received	Benefit received in UK
1	30 Sept	500			
1	31 Mar		800	1000	0
2	31 Mar	100	1000	1400	0
3	31 Mar	500	500		

4	30 Sept	200		1000	0
4	31 Mar		500		
5	30 Sept	500	100	600	600
5	31 Mar		400		

Year 1

The potential benefits charge is 1000 (being the lesser of 1300 relevant income and 1000 benefits received-see TAH 900).

As all of the conditions for Section 735 to apply are met, consider whether any of the potential charge is foreign deemed income. The principles in Section 735A are used for this purpose (TAH 1235).

- First match the 1000 with the UK income of 500. As this income cannot be relevant foreign income then 500 cannot be foreign deemed income and thus is charged under the transfer of assets benefits charge.
- The remaining benefit is then matched with the foreign income of 800 this income would be relevant foreign income if it was the individuals and thus 500 of the deemed amount is foreign deemed income. This is treated as relevant foreign income and becomes potentially chargeable under Part 8 ITTOIA 2005.
- There is a balance of 300 relevant income that remains unmatched.

Where any amount is remitted to the UK during that or any subsequent year which is a remittance for Chapter A1 Part 14 ITA 2007 (the Remittance Basis) then part or all of the ring fenced amount may be charged under Part 8 ITTOIA in the year of remittance, subject as appropriate to the rules on remittances from mixed funds (see the Residence, Domicile & Remittance Basis Guide (HMRC6).

The total taxable amount for the year under transfer of assets benefits charge is therefore 500.

Year 2

The potential benefits charge is 1400 (being the lesser of the total relevant income 2400 and the total benefits 2400 less 1000 already charged).

Calculate how much of the total potential charge can be regarded as foreign deemed income applying Section 735A-

The potential chargeable amount is in effect matched with-

(a) 300 of foreign income from year 1. This gives foreign deemed income of 300 chargeable under Part 8.

(b) 100 UK income of year 2. As this income cannot be relevant foreign income this amount of 100 remains chargeable under the transfer of assets benefits charge.

(c) The foreign income of year 2 of 1000. As this would be relevant foreign income if it were the individual's this amount can be regarded as foreign deemed income and so chargeable under Part 8.

The result is that of the potential charge of 1400, 100 is charged under transfer of assets benefits charge and 1300 is ring fenced and treated as relevant foreign income chargeable under Part 8 ITTOIA.

The total charge under the transfer of assets benefits charge is therefore 100.
Where any amount is remitted to the UK during that or any subsequent year which is a remittance for Chapter A1 Part 14 ITA 2007 (the Remittance Basis) then part or all of the ring fenced amount may be charged under Part 8 ITTOIA in the year of remittance, subject as appropriate to the rules on remittances from mixed funds (see the Residence, Domicile & Remittance Basis Guide (HMRC6).

Year 3

Although there is further relevant income in this year there are no unmatched benefits so there can be no potential charge under transfer of assets benefits charge so a consideration of S735 is not applicable.

Year 4

The potential charge is 1000 (being the lesser of the total relevant income 4100 and the total benefits 3400 less 2400 already charged).
Work out the deemed foreign income applying Section 735A-
The potential chargeable amount is in effect matched with

(a) The UK relevant income 500 from year 3.
(b) The foreign income of 500 from year 3. .

The total amount charged under the transfer of assets benefits charge is therefore 500.
500 is ring fenced as foreign deemed income and treated as relevant foreign income.
Where any amount is remitted to the UK during that or any subsequent year which is a remittance for Chapter A1 Part 14 ITA 2007 (the Remittance Basis) then part or all of the ring fenced amount may be charged under Part 8 ITTOIA in the year of remittance, subject as appropriate to the rules on remittances from mixed funds (see the Residence, Domicile & Remittance Basis Guide (HMRC6).
There is 700 of unmatched relevant income to take forward.

Year 5

The potential charge is 600 (being the lesser of the total relevant income 5100 and the total benefits 4000 less 3400 already charged).
Work out the deemed foreign income applying Section 735A-
The potential chargeable amount is in effect matched with

(a) The UK relevant income 200 from year 4.
(b) 400 of the foreign relevant income from year 4.

The total amount charged under the transfer of assets benefits charge is therefore 200.
400 is ring fenced as foreign deemed income and treated as relevant foreign income.
Where any amount is remitted to the UK during that or any subsequent year which is a remittance for Chapter A1 Part 14 ITA 2007 (the Remittance Basis) then part or all of the ring fenced amount may be charged under Part 8 ITTOIA in the year of remittance, subject as appropriate to the rules on remittances from mixed funds (see the Residence, Domicile & Remittance Basis Guide (HMRC6).
As the benefit was received in the United Kingdom a minimum of the ring fenced amount of this year will be charged under Part 8 ITTOIA and consideration would need to be given to whether there are further untaxed amounts of ring fenced

income that would be charged for this year applying the relevant remittance basis rules.
There is 1100 of unmatched relevant income to take forward.

19.35 Where is a benefit received?

The s.731 remittance basis requires one to identify:

(1) where a benefit is received (or at least, whether it is received in the UK);
(2) where anything derived from that benefit is received.

Just as every asset has a situs (and only one situs), it is considered that every benefit should have one (and only one) place of receipt. But to identify the place of receipt of a benefit is (at least) as hard (and arbitrary) as to identify the situs of property or the source of income, problems to which the courts have failed to find wholly satisfactory answers.

Where the benefit is the outright transfer of an asset, it is suggested that the benefit is received in the place where the asset is situate under private international law principles. So if the benefit is the transfer of money paid to a beneficiary's bank account it is received where the account is kept. If the benefit is the transfer of a debt or shares, it is received where the debt or shares are situated.

19.35.1 *Interest-free (or low-interest) loan*

Where is the benefit of an interest-free (or low-interest) loan received? The possible solutions are:

(1) where the money lent is received;
(2) where the debt is situate under private international law principles.[94]

The objection to solution (1) is that the benefit is not the money lent, it is the interest forgone. It is suggested that the best solution is that the benefit

94 See 59.10 (Simple contract debt) and 59.11 (Specialty obligation).

is received where the debt is situate.[95] It is arguable that the money lent is derived from the benefit.[96]

The same solution would apply if the benefit was leaving outstanding a debt which was not a debt for money lent, for instance, if the offshore person sold an asset for full value to the individual and left the purchase price outstanding.

19.35.2 *Rent-free (or low-rent) use of chattel or land*

The position is different if the benefit is rent-free (or low-rent) use of a chattel or land. The chattel or land (unlike money in an interest-free loan) does not belong to the bailee, and the benefit is received where the land is situated or chattel is for the time being.

19.35.3 *Release of debt*

Suppose:

(1) money is lent to a beneficiary;[97]
(2) the loan is later released (a benefit).

Where is this benefit received? Again the choice is:

(1) where the money lent (or the proceeds representing it) was received or is situate;
(2) where the debt is situate.

The argument is similar to the discussion above on interest-free loans. The better view is that the place of receipt is where the debt is situate. The same

95 Another possible solution is to ask where the situs of the source of the interest would be for IT purposes, if interest were payable on the loan. But this should be rejected since (1) the rules for identifying the source of interest are hopelessly unclear and (2) when interest is not payable this would be a difficult hypothetical question to answer.

96 See 10.14.5 (T lends to R).

97 It makes no difference whether the loan is at a commercial rate (not a benefit), or an interest-free loan (which confers the separate benefit of interest foregone until the date of release).

applies on the waiver of interest, but there it is even clearer that solution (1) is not correct. The money lent is not, strictly, derived from the benefit.

19.35.4 *Receipt of benefit outside UK and subsequent remittance*

Suppose:

(1) a UK resident foreign domiciled individual receives a benefit in the form of the transfer of money (or a chattel) outside the UK, and
(2) later remits that money (or chattel) to the UK.

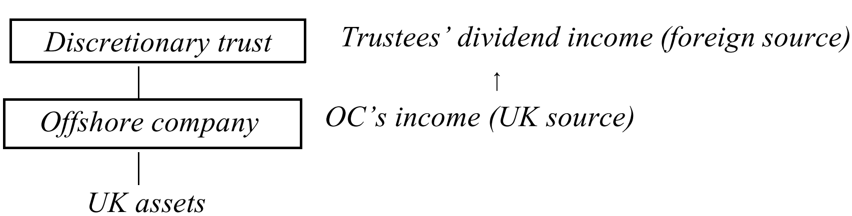
The benefit becomes taxable under the s.731 foreign domicile remittance basis. Before 2008 the contrary was arguable.

For this reason, the tax consequence of a benefit received by one beneficiary may depend on whether *other* beneficiaries have remitted their benefits (and so used up relevant income). One might expect one beneficiary (with access to trust documents) to be able to find out what benefits other beneficiaries have received and where. But a beneficiary is not entitled to find out and often will be unable to find out what benefits received by other beneficiaries have been remitted. The legislation is in some cases unworkable. But by 2008 workability has ceased to be a requirement of anti-avoidance legislation.

The beneficiary is not ordinarily resident when he receives the benefit but is ordinarily resident when it is received in the UK, there is not tax charge.

19.35.5 *Distribution of UK source income*

Suppose an offshore company ("OC") within s.731 is owned by a trust within s.731:



If OC receives and retains UK source income, that is not foreign relevant income. However, if OC distributes the income to the trust, OC's income ceases to be relevant income. Instead the income of the trust is relevant income (unless distributed), but this income is foreign source income and so in principle excluded relevant income. So where UK source income is received by a trust subsidiary company, the s.731 defence can be made available by distribution of that income from the company, This seems anomalous. However, s.731 provides a rough justice in other areas where that favours HMRC, so it is not altogether surprising if on this occasion an anomaly may favour the taxpayer.

19.36 Section 720 and 731 remittance basis compared

Sections 720 and 731 both offer a form of foreign domicile defence. The s.720 defence is more generous. So a transferor (chargeable under s.720 but not s.731) will often be in a better position than other beneficiaries (chargeable under s.731)! For example:

(1) Suppose T (UK resident, foreign domiciled) creates a trust within s.720. T occupies a property owned by the trust. The trust also receives and accumulates foreign income. There is no tax charge. T is not subject to tax under s.720.
(2) Now suppose T dies and B occupies the same property. B is taxed on the benefit of the rent-free accommodation under s.731. The s.731 remittance basis does not help B because the benefit is received in the UK.

19.37 Summary of responses to s.731

(1) Avoid relevant income by
    (a) distributing income:
        (i) as it arises; or
        (ii) in a year before a beneficiary receives a benefit; or
    (b) using interest in possession settlements in preference to discretionary; or
    (c) not using trusts and companies where inappropriate.
(2) Tax motive defence.
(3) Foreign domicile defence.
(4) Arrange that foreign domiciled beneficiaries receive benefits of an income nature (outside s.731).

CHAPTER TWENTY

TRANSFER OF ASSETS ABROAD: DOUBLE TAXATION ISSUES

20.1 TAA reliefs – Terminology

The transfer of asset rules could often give rise to double taxation, and there are four reliefs to prevent this. Statute does not provide names for the reliefs, so I coin the following terminology:

Name of Relief	Section	Outline of Relief
Transferor's credit	745(1) ITA	Credit for tax paid by transferee
Transferee's concessionary credit	Concession	Credit for tax paid by transferor
Distribution relief	743(4) ITA	Relief on distribution to transferor
Double-counting relief	743(1) ITA	Vaguely expressed double taxation relief

For the separate issue of DTTs and foreign tax credits, see 41.9 (Section 720 ITA) and 41.10 (DT reliefs: s.731 ITA).

20.2 Undistributed UK taxable income of offshore company

Suppose an offshore company ("OC") receives and retains UK taxable income,[1] say, rental income. If s.720 ITA did not apply, there would be one charge to tax: income tax borne by OC. However, if s.720 applies, it a ppears at first sight that there are two charges to tax:

1 OC's income may be UK taxable because:
- (1) the income has a UK source and so is subject to income tax; or
- (2) OC is a UK resident foreign incorporated company and so is subject to corporation tax.

(1) OC pays income tax at the basic rate under ordinary principles.
(2) The transferor ("T") pays income tax on the same income under s.720.

What is there to prevent double taxation?

20.2.1 *Transferor's credit*

Section 745(1) ITA provides relief for T:

> Income tax at the basic rate, the starting rate for savings or the dividend ordinary rate shall not be charged by virtue of section 720 or 727 in respect of any income to the extent that it has borne tax at that rate by deduction or otherwise.[2]

I refer to this as "**transferor's credit**".

The credit is available where OC is a UK resident foreign incorporated company even though such a company is subject to corporation tax at CT rates (not income tax at the basic/savings/dividend ordinary rates). HMRC say:

> If tax has been paid on the income of the person abroad on which you are also liable to tax under these provisions and which you have entered in Column B before box 13 then you may be able to claim a deduction against your liability for that tax. You will only be entitled to relief for the tax paid by the person abroad if it is in effect tax on 'the same' income, and only to the extent that the tax has actually been paid by, and not refunded to, the person abroad. This could include in some circumstances, for example, UK Corporation Tax. Relief for the tax paid, including any UK Corporation Tax, should be included at Column C and you should note Column E of your claim. Full details of how you have calculated the amount of credit claimed, and details (name, address and, where appropriate, tax reference number) of the person or company which paid the tax should be given in the 'Any other information' box

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2 This was considered in *R v Dimsey & Allen* 74 TC 263 at [53]:

> "This provision would have dealt with the case where the transferee's income included income sourced in the UK and from which tax had already been deducted at source. But the words 'or otherwise' show that the provision would have covered also any case in which the transferee had paid tax on its income."

> of your Tax Return. If you do not yet know the final amount of tax paid by the person abroad, you should estimate the amount of credit available and amend your Tax Return when the final details are known. You must draw attention to the estimate and explain the circumstances in the 'Any other information' box of your Tax Return. If any additional tax becomes payable as a result of using an estimate the usual provisions for charging interest on tax paid late will apply.[3]

The guidance note for 2006/07 added:

> We will consider providing details of Corporation Tax paid upon receipt of written authority from the company concerned[!].[4]

20.2.2 *Transferee's concessionary credit*

The limitation of the transferor's credit was explained in *R v Dimsey & Allen* 74 TC 263 at [56]:

> Section [745(1)] ... is looking at the double taxation problem from the point of view of the transferor on whom the liability to pay tax on deemed income is being imposed. There is no comparable provision protecting the transferee in a case where, under s [720], the transferor has paid tax on his deemed income.

In the course of argument in *R v Dimsey & Allen*, HMRC announced a concession to solve this problem:

> **The Inland Revenue's Practice on section [720]**
> [1] If in any case tax is paid by the transferee, the Inland Revenue will give credit for that tax against any charge to tax on the transferor under section [720 ITA] on the same income;
> [2] and conversely, if in any case tax is paid on any income by the transferor under section [720], the Inland Revenue will not tax the transferee on that income.

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3 Help sheet 262 (income and benefits from transfers of assets abroad) 2007/08. In *R v Dimsey & Allen* 74 TC 263 at [55] Lord Scott suggested (without deciding) that transferor's credit would apply in this case. But see 17.4.1 (UK resident foreign incorporated company) for an argument that s.720 does not apply here.

4 "Notes on Foreign" (the Notes on the Foreign pages of the tax return for the year ended 5 April 2007, under the heading "box 6.4A", page FN11).

> So that in every case, the Treasury received in all the full amount of tax chargeable on the transferor as if he were the only person liable.

Point [1] is the transferor's credit. I refer to point [2] as "**the transferee's concessionary credit**". The consequence is that either:

(1) T pays all the tax on the income (and OC pays none); or
(2) (a) OC pays tax (usually basic or dividend ordinary rate); and
    (b) T has the credit for OC's tax (so he usually pays higher rate tax only).

This concession does not say whether (1) or (2) is to be the case. As far as HMRC are concerned it does not matter because the amount of tax collected will generally be the same. If T is the beneficial owner of OC, it may likewise not make much economic difference to T whether T or OC pay the tax. But T may have "power to enjoy" the income of OC while only having a remote and not particularly valuable interest in it.[5] One can imagine a situation where T and OC each ask HMRC to assess the other! There is no mechanism for tax paid by T to be recovered from OC or vice versa. HMRC have a broad discretion, subject to judicial review if they act unreasonably. How in practice should HMRC collect tax? It is suggested that HMRC's starting point should be that tax is to be borne by OC where tax is reasonably collectible from OC, i.e. if:

(1) the income is dividend income with a tax credit (in this case, of course, no one has any choice about the matter);
(2) tax is collectible under the non-resident landlord regulations, i.e. if OC complies with its duties under those regulations; or
(3) OC is prepared to complete UK tax returns and pay the tax on its income.

It is fair that OC, which receives the income, should pay the tax on it. Then only higher rate tax is normally collected from T. Only in cases where OC refuses to pay should all the tax be collected from T. This seems consistent with the extract from "Notes on Foreign" cited above.

5 For instance, if OC owes T a small debt.

It is arguable that double-counting relief also provides a defence to double taxation.[6] If this is correct, the transferee's concessionary credit is the law and not a concession.

20.3 Distribution to T of income of company within s.720

So far we have been considering undistributed income of OC. I now turn to consider the position where the income is distributed to T by way of dividend. Suppose:

(1) An offshore company ("OC") within s.720 receives income ("OC's income").
(2) T owns all the shares in OC.[7]
(3) The income of OC is distributed by way of dividend to T ("the dividend income").

Possible charges to tax here are:

(1) IT on OC's income paid by T under s.720.[8]
(2) IT on the dividend (paid by T) on normal principles.

Is there any relief from economic double taxation?

20.4 Distribution relief

Section 743(4) ITA provides:

> If
> [a] income treated as arising to an individual is charged to income tax under section 720 or 727 and
> [b] the individual subsequently receives *that income*,
> it is treated as not being the individual's income again for income tax purposes.

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6 See 20.6 (Double-counting relief).

7 The position is not materially different if the shares in OC are held in a trust under which T is life tenant.

8 Or IT on OC's income paid by OC and T, but with credit to avoid double taxation: see above. That makes no difference for the purpose of this example. It is assumed here that T does not qualify for the remittance basis.

(Emphasis added)

I refer to this as "**distribution relief**". There are three conditions for this relief to apply:

(1) Income treated as arising to the individual is charged to income tax under s.720.
(2) The individual receives the income.
(3) The dividend income which the individual receives is "that income", i.e. the same as the income treated as arising to the individual.

Condition (1) would normally be satisfied.[9] Condition (2) is *ex hypothesi* satisfied.

20.4.1 *When is income "the same" for purposes of distribution relief?*

At first sight condition (3) is more doubtful. The income which the individual actually receives is the dividend income. The income which the individual is treated as receiving under s.720 is the income of OC.[10] The two are not the same. But if that is correct, then s.743(4) can never apply at all, which cannot be correct.

OC's income and the dividend income are in substance or economic reality the same income. It is true that they are usually regarded for tax as separate sources of income, not the same income. "The income of the company and the income derived from the company by the shareholders are two quite different incomes".[11] Nevertheless for this purpose one looks to the substance and does not apply the formalistic view. This would be reasonably clear even in the absence of authority, because (on

9 See 20.2 (Undistributed UK taxable income of offshore company); 20.7.2 (When is an individual "charged to tax" under s.720?).

10 Or on an alternative view, the income which the individual is treated as receiving is fictional, notional income, but for the purposes of distribution relief it does not matter if that view is correct.

11 *Vestey v IRC* 54 TC 503 at 562. This is obvious but if further authority is needed, see *Canadian Eagle Oil Co v The King* 27 TC 205 at 257: "for the purposes of Income Tax, the income of a foreign company and the income received from it in dividends by its British shareholders are not to any extent or effect one and the same income, but are two distinct incomes".

the formalistic view of income identity) it is impossible for T to receive the "same" income as OC. The source must change when T receives it.

This view is directly supported by *Aykroyd v IRC*.[12] The facts were relatively simple. T (UK domiciled) held an offshore holding company (within s.720) which held an offshore subsidiary (within s.720):[13]

T	
Offshore Holding Co	*Offshore Holding Co income*
	↑
Offshore Subsidiary	*Offshore Subsidiary Income*

(1) In 1936/7 the offshore subsidiary received income within s.720 ("the offshore subsidiary income").
(2) In 1937/8 the offshore subsidiary paid that income by way of dividend to the offshore holding company ("the offshore holding co income"). This income was also within s.720.
(3) The transferor ("T") was assessed on the offshore holding co income in 1937/8. He was not assessed on the offshore subsidiary income in 1936/7.

This was not an individual/company structure but a company/subsidiary structure, but in the context of distribution relief the issue is the same.

T argued that he could be assessed at stage (1) and so he could not be assessed at stage (2). He relied on distribution relief. Macnaghten J accepted (rightly) that the relief could apply to the sequence of two dividends:

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12 24 TC 515. The substance (as opposed to the formalistic) view of income identity is also applied in other contexts in the transfer of assets code. In *Vestey v IRC* Walton J held that a shareholder had no "power to enjoy" the income of the company in which he held shares because (applying the formalistic view of income identity) the shareholders had power to enjoy *different* income! However, this view was rejected in the House of Lords. See 18.6.4 (Enjoyment condition D: possibility of benefit). Similarly the court looked at the economic substance in order to determine whether two assets were "the same" (for the purposes of stamp duty subsale relief) see *Fitch Lovell v IRC* [1962] 1 WLR 1325.

13 More accurately, there were several holding and subsidiary companies, but nothing turns on that.

> If the Appellant had in fact been charged in the year 1936–37, he could not have been charged again in the year 1937–38.

That is, the offshore holding co. income was (for the purposes of distribution relief) the same income as the offshore subsidiary income.

20.4.2 *Distribution relief: conclusion*

Thus, even though OC's income is distributed to T:

(1) there is only one tier of income tax, the charge under s.720;
(2) T has the benefit of tax credits or DT Relief relating to OC's income.

At first sight this seems anomalous. If s.720 did not apply (e.g. because the individual owning OC was not the transferor or because the motive defence applied) then the position is quite different:

(1) there will be two charges to tax if OC's income is UK source:
    (a) income tax on OC's income paid by OC under ordinary principles; and
    (b) income tax on the dividend paid to T.
(2) T does not have the benefit of tax credits or DT Relief relating to OC's income.

On reflection, there is no anomaly. The object of s.720 is to put the transferor in the same position as if he had not made the transfer: see *Chetwode v IRC* 51 TC 647.

20.4.3 *Identifying income qualifying for distribution relief*

It may happen that the income of OC for company law purposes is greater than the income of OC for tax purposes (e.g. because of capital allowances). Distribution relief applies only so far as the income of the company has been subject to tax under s.720. For example, OC may have taxable income of 10, but accounting profits of 100. If OC declares a dividend of 100, then the charges to tax are:

(1) IT on OC's income of 10 on T under s.720.
(2) IT on the dividend on the amount of 90 (i.e. 100–10).

In these circumstances, the use of an offshore company does give rise to tax on the distribution which would not have arisen if there were no company.

Suppose OC receives £100 and spends £20 on expenses, but, the company having spare assets available for distribution, £100 is nevertheless distributed. It is suggested that the dividend of £100 should be identified with OC's income of £100 and so qualifies for distribution relief in its entirety. The £20 spent on expenses is attributed to other assets, even though as a matter of tracing it was paid for out of the s.720 income. The position is analogous to the *Duke of Roxburghe* case.[14]

20.4.4 *Planning: distribution and re-settlement*

Where distribution relief can apply it is generally worthwhile distributing income to T and letting T re-settle the income if he wishes. If this is not done during T's life, the benefit of the relief is lost later; see below.[15]

20.5 Distribution (*not* to T) of income of company within section 720

Suppose:

(1) An offshore company ("OC") within s.720 receives income ("OC's income");
(2) T is not a shareholder in OC but has "power to enjoy" the income;[16]
(3) P (a UK resident third party) owns all the shares;[17]
(4) the income of OC is distributed by way of dividend to P.

In these circumstances it appears that there is economic double taxation:

(1) OC's income is subject to tax in the hands of T (or T and OC) under s.720.

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14 See 9.33 (Remittance from mixture of taxed and untaxed income).

15 This may also be done to avoid relevant income accumulating in a company held by a trust; see 18.29 (Is income of company held by a trust relevant income?).

16 He may have power to enjoy by reason, perhaps, of a debenture or through being a beneficiary of the trust which holds OC.

17 The position is not materially different if the shares in OC are held in a trust under which P is life tenant, and to which s.624 ITTOIA does not apply.

(2) P is subject to tax on the dividend.

Distribution relief does not apply because that relief only applies where OC's income is subsequently received by the transferor, T. The transferor credit and the concessionary transferee credit do not cover this situation. However, double-counting relief applies.

20.6 Double-counting relief

Section 743 ITA provides:

> **743 No duplication of charges**
> (1) No amount of income may be taken into account more than once in charging income tax under this Chapter.
> (2) If there is a choice about the persons in relation to whom any amount of income may be taken into account in charging income tax[18] under this Chapter, it is to be taken into account—
> (a) in relation to such one or more of them as appears to an officer of Revenue and Customs to be just and reasonable, and
> (b) if more than one, in such respective proportions as appears to the officer to be just and reasonable.

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18 Section 744 ITA provides:

"**744 Meaning of taking income into account in charging income tax for section 743**
(1) References in section 743(1) and (2) (no duplication of charges) to an amount of income taken into account in charging income tax are to be read as follows.
(2) In the case of tax charged on income under section 720 (charge where income enjoyed as a result of relevant transactions)—
(a) if section 724(1) (benefit provided out of income of person abroad) applies, they are references to an amount of the income out of which the benefit is provided equal to the amount or value of the benefit charged, and
(b) otherwise they are references to the amount of income charged.
(3) In the case of tax charged on income under section 727 (charge where capital sums received as a result of relevant transactions), they are references to the amount of that income.
(4) In the case of tax charged under section 731 (charge to tax on income treated as arising to non-transferors where benefit received as a result of relevant transfers), they are references to the amount of relevant income taken into account under section 733 (income charged under section 731) in calculating the amount to be charged in respect of the benefit for the tax year in question."

I refer to this as "**double-counting relief**". This provision is vaguely worded, but I suggest it prevents double taxation:

(1) Where T1 is charged under s.720 and T2 is charged under s.720; i.e. there are two transferors (but *Vestey* decided that there can only be one transferor).
(2) Where T1 is charged under s.731 and T2 is charged under s.731; e.g. where two different individuals receive benefits, the s.733 computation often prevents a double charge (but not always).[19]
(3) Where T1 is charged under s.720 and T2 is charged under s.731.[20]
(4) Where T1 is charged under general principles and T2 is charged under s.720 or s.731.

This therefore applies in the circumstances of the example of para 20.5 (Distribution (*not* to T) of income of company within s.720). Before the enactment in 1981 of double-counting relief, there was economic double taxation in these circumstances. Lord Greene did not regard this as double taxation. In an obiter comment in *Howard de Walden v IRC* 25 TC at 131, decided in 1940, he said:

> [Counsel] pointed out that in so far as the right to enjoy income of the four companies is vested in the Appellant's son, who holds the majority of the shares, income received by the son will be taxed in his hands in the ordinary way and at the same time the Appellant will be liable to tax on the whole income of the companies which is deemed to be his. This, said [Counsel], involves double taxation since no relief is afforded by [what is now s.726 ITA]. There is a short answer to this argument. There is no double taxation since the subject-matter of tax is different, the income of the son being one thing and the income of the companies being another.

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19 See 19.11.5 (Available Relevant income).

20 Although the words in s.743(1) could be construed to apply to situation (3) only, that would be absurd. Indeed, it is unusual that income could be taxed under s.720 and s.731. An example might be if income accrues which is not within s.720 because it is not remitted to the UK, then there is a charge under s.731, and then there is a remittance. Another example might possibly be if s.720 does not apply (because the transferor has no "power to enjoy") but subsequently there is a capital payment within s.727. Another possible case is in 19.17 (Is income within s.720 relevant income?).

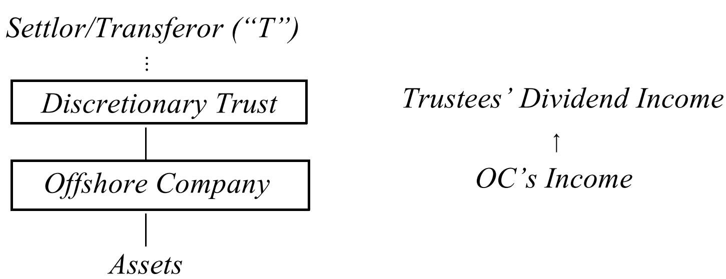
Several passages of *Howard de Walden* exhibit an anti-taxpayer ethos which may be attributed to the war-time background; "as we are at war", as Darling J said in another context, "the ordinary mode of construing legislation has been suspended".[21]

Formalistically Lord Greene is right, the situation is one of economic rather than formalistic double taxation. However, since the purpose of distribution relief is to avoid economic double taxation, both fairness and the scheme of the Act suggest that double-counting relief should do the same work in this context. It is considered that Lord Greene's comment does not support the contrary view.

In practice this situation is rare as T either has no "power to enjoy" and so is outside s.720, or else he is life tenant/shareholder and receives the dividends personally and distribution relief applies.

20.7 Section 720 trust/company and company/subsidiary structure

So far we have been considering the (relatively) simple situation where OC is held by an individual (or an IP trust). We now turn to consider the position where OC is held by a non-resident discretionary trust. That is, trustees of a discretionary trust within s.720 ITA and s.624 ITTOIA hold a non-resident company within s.720:



Suppose:

(1) Income is received by the OC ("OC's income" at "stage (1)").
(2) OC's income is paid to the trustees as dividend income ("the trustees' dividend income" at "stage (2)").

21 Cited "*R v Halliday* in Retrospect" [2003] LQR 455 (David Foxton).

In principle this might give rise to two tax charges on T:

(1) OC's income charged under s.720 at stage (1);
(2) the trustees' dividend income charged under s.720 or s.624 at stage (2).

What is there to prevent double taxation?

20.7.1 *Distribution relief*

It will be recalled that distribution relief applies if:[22]

(1) OC's income is within s.720;
(2) the trustees' dividend income is received by T;
(3) the trustees' dividend income is "that income" (i.e. the same income as OC's income);
(4) the individual is charged to income tax on OC's income under s.720.

Condition (1) is satisfied. Condition (2) is satisfied because income is treated as received by T. Condition (3) is also satisfied: see 20.4.1 (When is income "the same" for purposes of distribution relief?).

20.7.2 *When is an individual "charged to tax" under section 720?*

The next requirement of distribution relief is that the income treated as arising to the individual must be "charged to income tax under section 720". In *Aykroyd*[23] T failed because he had not been so "charged":

> It was suggested that, if the [offshore subsidiary's income] were liable to assessment for the year 1936–37, that provision [s.743(4)] prevented them being chargeable in the following year. But that argument depended on the substitution of the word "chargeable" for the word "charged". There is no ground that I can see for making any such substitution. ... as he had not been charged in the previous year, there was nothing to prevent him being charged in the year in question.

22 See 20.4 (Distribution relief).
23 See 20.4.1 (When is income "the same" for purposes of distribution relief?).

This is not obiter, but it is at first sight surprising and it certainly does not appear from the Judge's terse comment that the Court had the benefit of a full argument on the point.

Is it right? The word "charged" (like most words) takes its meaning from context. It may mean:

(1) declaration of liability by statute;
(2) assessment (including self-assessment);
(3) payment.[24]

The most common and primary sense of the word "charged" is that it refers to the declaration of liability. Every year, for instance, the FA provides that income tax shall be charged for that year: see e.g. s.31 FA 2000. This is the statutory declaration of liability. It is not referring to the making of assessments or collection of tax.

However, this meaning poses difficulties for HMRC who may not know that a s.720 liability arises or may be unable to make an assessment. So the *Aykroyd* interpretation that "charged" means "paid" is probably correct.

This does not mean that HMRC have an unfettered discretion:

(1) to assess T on the subsidiary company's income; or
(2) to assess T on the holding company's income.

Under self-assessment, T will normally self-assess his income and should in principle return the income of the offshore subsidiary as his income and distribution relief applies. However, where T does not pay tax due on the offshore subsidiary's income HMRC can collect tax on the offshore holding company's income and distribution relief does not apply.

Often it may not matter whether tax is charged on the offshore subsidiary's income or the offshore holding company's income. However, it may matter:

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24 These correspond to the three stages in the imposition of a tax:

> "there is the declaration of liability, that is the part of the statute which determines what persons in respect of what property are liable. Next, there is the assessment. ... assessment particularises the exact sum which a person liable has to pay. Lastly, come the methods of recovery, if the person taxed does not voluntarily pay."
>
> *Whitney v IRC* 10 TC 87 at 109.

(1) For identifying the source of the income to which s.720 applies. Is the transferor taxed under s.720 in respect of the subsidiary's income or the holding company's income? This may affect:
   (a) rates of tax, e.g. if the underlying company receives interest or rental income it makes a difference between:
      (i) 40% (higher rate due on interest); and
      (ii) 32.5% (dividend upper rate on a foreign dividend);
   (b) availability of transferor's credit for UK tax paid by the company and double tax relief.
(2) It may also affect the year in which the income is subject to tax.

20.7.3 *Double-counting relief*

This provision is discussed in 20.6 (Double-counting relief). It will apply in a s.720 trust/company or company/subsidiary structure but where distribution relief covers the same ground it should not be needed.

20.7.4 *Trust/company structure: HMRC practice*

RI 201 provides:

> where income arises in an offshore company underlying a settlement and the income is not paid up immediately to that settlement the provisions of section [720 ITA] will be invoked where necessary to assess the income of the underlying company.

The position therefore depends on whether income is paid up "immediately".

(1) *If the income is not paid up immediately*. The provisions of s.720 will be invoked. This is clearly correct. RI 201 does not address the question (discussed above) of relief for a subsequent dividend by the underlying company.
(2) *If the income is paid up immediately*. RI 201 implies that:
   (a) s.720 will not be applied so OC's income (if non-UK source) will not be taxed; and
   (b) the settlor will be taxed on the trust income under s.624 ITTOIA in the normal way.

An important question is exactly the moment when one moves from (1) to (2). What is the meaning of "immediately"? Does it mean within a day? Or a week? Or at any time within the same tax year? Or at any time before the relevant returns are due or submitted? Do HMRC have a discretion? Does the answer depend on the type of income? One must bear in mind that some forms of income cannot be quantified until the end of an accounting period (e.g. trading and rental income).

If income is distributed immediately, RI 201 does not address the question whether the settlor is taxed (under s.624 ITTOIA) on the underlying company's income or on the dividend. It makes a difference if the underlying income has a tax credit.

This is a sorry muddle. In practice, the author suspects that HMRC apply the "immediately" concept with latitude and are not concerned as long as they can see that income comes into tax in one year or another, in one form or another.

20.7.5 *Trust/company structure: further example*

Suppose in the trust/company structure illustrated at 20.7 (Section 720 trust/company and company/subsidiary structure) the company:

(1) receives £100 income;
(2) spends £20 of the £100 it received on expenses (not deductible for the purposes of s.720); and
(3) distributes £80.

It is suggested that £100 is taxable at stage (1) and the £80 is tax free at stages (2) and (3). Close examination of RI 201 (see above) suggests HMRC might assess £20 at stage (1) and £80 at stage (2). It is doubtful whether the statement is meant to bear close examination, but it makes little difference in practice.

20.8 Life policies

In *IRC v Willoughby* 70 TC 57 Professor Willoughby ("T") transferred assets to a non-resident life insurance company as a premium for a life policy. T was not taxed on the income accruing to the insurance company as the motive defence applied. Had the defence failed, there would in principle[25] have been double taxation:

(1) T would pay income tax on income arising to the life insurance company (to the extent that it arose as a result of T's premium); and
(2) T would pay income tax on the gain arising from the policy under the chargeable event provisions.

The Special Commissioners noted correctly that distribution relief did not apply. The chargeable event gain was not the same as the income. The potential double taxation is one reason for applying the motive test generously.

The decision records that HMRC offered relief against double taxation: see at p.83. It appears from this and the transferee's concessionary credit that HMRC are often willing to offer such concessions, at least if it is thought to give them a tactical advantage in litigation.

20.9 Section 731 charge followed by income distribution

I now turn to consider double taxation issues relating to s.731. The transferor's credit, the transferee's concessionary credit and distribution relief only apply to s.720, so they have no relevance here.

Suppose:

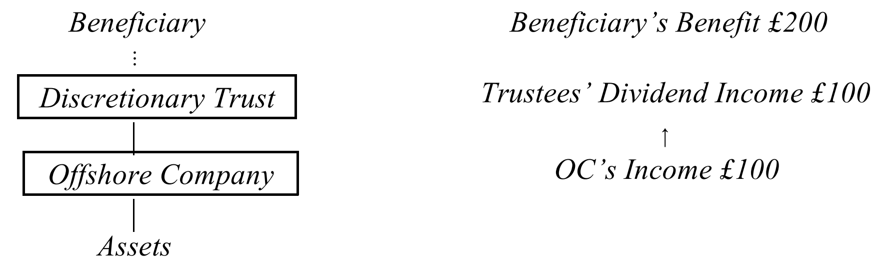
(1) trustees of a trust receive income and do not distribute it;
(2) a beneficiary receives a benefit taxable under s.731;
(3) the income is later distributed to the beneficiary as income.

It is understood that the distributed income is not taxed. This might be regarded as informal concession but the better view is that double-counting relief applies here.

20.10 Section 731 trust/company structure[26]

The problem is best illustrated by example:

25 Relief is arguably available under s.527 ITTOIA.
26 Contrast 20.7 (Section 720 trust/company and company/subsidiary structure).



Trustees of a discretionary trust within s.731 hold a non-resident company within s.731.

(1) £100 income is received by the company ("the company's income" at "stage (1)").
(2) The £100 is paid to the trustees as dividend income ("the trustees' dividend income" at "stage (2)").
(3) A beneficiary ("B") receives a benefit of £200.

Is the relevant income £100 or £200? That is, does the interposition of the company double the relevant income? If so, then the s.731 charge on B is in principle on £200.

It is suggested that double-counting relief applies; see 20.6 (Double-counting relief).[27]

27 If that is wrong, then a second argument is that after the company's income is distributed it ceases to be relevant income. See 19.24 (Corporate income distributed to trust). This argument will not avail if the facts are a variant of the above example:

(1) £100 income is received by the company;
(2) a beneficiary receives a benefit of £200;
(3) the £100 is subsequently paid to the trustees as dividend income.

For then even if the company's income ceases to be relevant income after being distributed, it does so too late.

CHAPTER TWENTY ONE

TRANSFER OF ASSETS ABROAD: MOTIVE DEFENCE

21.1 Motive defence – Introduction

Sections 736 to 742 ITA provide a defence to the TAA provisions which I call "**the motive defence**".[1] This area of law was never easy, but the FA 2006 made it almost twice as complicated: it introduced stricter and obscurer rules which apply to transactions from 5 December 2005, while retaining the old rules for earlier transactions.[2]

Section 736(3) ITA provides two self-explanatory terms:

> In this section and sections 737 to 742—
>
> "**post-4 December 2005 transaction**" means a relevant transaction effected on or after 5 December 2005, and
>
> "**pre-5 December 2005 transaction**" means a relevant transaction effected before 5 December 2005.

In this chapter:

(1) "**Old Conditions A and B**" are conditions A and B in s.739 ITA (applying to pre-5 December 2005 transactions).
(2) "**New Conditions A and B**" are conditions A and B in s.737 ITA (applying to post-4 December 2005 transactions).

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1 The word "motive" is not used in the legislation, but the label is convenient and reasonably accurate. It originates from the Inland Revenue's Notes on clause 18 Finance Bill 1936.

2 EN FB 2006 stated:

> "The new provisions recast the test for exemption in cases not involving a tax avoidance purpose to make its meaning clearer."

But no-one is intended to take that seriously.

References to Condition A or B (without more) means either the old or the new version of the Conditions.

There have been two explanations of the 2006 clauses: Explanatory Notes on the Draft Clauses, published 5 December 2005, and Explanatory Notes on the Finance Bill 2006. I refer to these as "**EN Draft Clauses (2005)**" and "**EN FB 2006**".

I distinguish between:

(1) An "**innocent**" transfer, one which satisfies Condition A or B (in short, no tax avoidance purpose); and
(2) a "**tainted**" transaction, one which does not satisfy Condition A or B.

For the definition of "**relevant transactions**" see 17.10 (Significance of associated operation).

21.2 Motive defence condition A

Section 737 ITA sets out New Condition A:

> **Exemption: all relevant transactions post-4 December 2005 transactions**
> (1) This section applies if all the relevant transactions are post-4 December 2005 transactions.
> (2) An individual is not liable to income tax under this Chapter for the tax year by reference to the relevant transactions if the individual satisfies an officer of Revenue and Customs—
> (a) that Condition A is met, or
> (b) in a case where Condition A is not met, that Condition B is met.
> (3) Condition A is that it would not be reasonable to draw the conclusion, from all the circumstances of the case, that the purpose of avoiding liability to taxation was the purpose, or one of the purposes, for which the relevant transactions or any of them were effected.

Section 739 ITA sets out Old Condition A:

> **739 Exemption: all relevant transactions pre-5 December 2005 transactions**
> (1) This section applies if all the relevant transactions are pre-5 December 2005 transactions.

> (2) An individual is not liable for income tax under this Chapter for the tax year by reference to the relevant transactions if the individual satisfies an officer of Revenue and Customs that condition A or B is met.
> (3) Condition A is that the purpose of avoiding liability to taxation was not the purpose, or one of the purposes, for which the relevant transactions or any of them were effected.

21.3 Motive defence condition B

Section 737(4) ITA sets out New Condition B:

> Condition B is that—
> (a) all the relevant transactions were genuine commercial transactions (see section 738), and
> (b) it would not be reasonable to draw the conclusion, from all the circumstances of the case, that any one or more of those transactions was more than incidentally designed for the purpose of avoiding liability to taxation.

Section 739(4) ITA sets out Old Condition B:

> Condition B is that the transfer and any associated operations—
> (a) were genuine commercial transactions, and
> (b) were not designed for the purpose of avoiding liability to taxation.

21.4 Enactment history

The original wording was much simpler. It provided exemption if:

> the transfer and any associated operations were effected mainly for some purpose other than the purpose of avoiding liability to taxation.[3]

The Solicitor-General explained why the text was changed to (what is now) Old Conditions A & B:

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3 Section 18 FA 1936. Section 28 FA 1938 substituted the text which is now Old Conditions A and B.

> A taxpayer[4] transferred a large amount – he was not one of the small people for whom my hon. and learned Friend was pleading – of foreign securities to a trust company abroad on certain trusts under which the income was to be accumulated until the death of the taxpayer. There was a discretion to the trustees to pay certain portions of the income to the taxpayer or to his son. The deed gives to the taxpayer and his son power, with the consent of the trustees, to revoke the trust, or, alternatively, they can withdraw all or any part of the trust property for their own benefit. The trust income has been accumulated, and none of it has been distributed. The vigilant Revenue authorities pursued this taxpayer, and he contended, successfully, as it transpired, on appeal, that the foreign trust was born because of his fears as to the financial position of this country and the dangers of the situation on the Continent ... in 1936. He stated that he wanted to find a stable country where he could make safe provision for his family. The Special Commissioners decided that the main purpose of the transaction was occasioned by A's pessimistic view of the European situation at the time; that, arising out of that, his main intention was to make provision for his family in a safer country; and that, if there was any intention of avoidance of taxation, it was incidental to the main purpose. They therefore decided that there was no liability under Section 18 FA 1936. That instance has only to be cited to the Committee for the Committee to realise that on this particular matter the hon. Member for Chesterfield (Mr. Benson) was a true prophet in 1936, when he said that the word "mainly" would be too wide.[5]

A case on similar facts might still succeed today, but the test is stiffer. The taxpayer would need (in short) to show that tax avoidance was not even one of the purposes of the transfer.[6]

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4 Presumably a UK resident and domiciled transferor. (HMRC did not contend at that time that (what is now) s.720 applied to a transferor unless UK resident at the time of the transfer, and a foreign domiciled transferor would have qualified for the remittance basis.) So one can see why HMRC found the case troubling in 1938.

5 Hansard 27 June 1938, col 1610. It is impressive that an income tax dispute relating to 1936/7 was resolved by a Special Commissioners' decision early in 1938.

6 One might argue that the transfer was commercial (Condition B) but that is not so on the view adopted in this book.

21.5 "Commercial" in Old Condition B

Commercial is a requirement for Condition B but not Condition A. In Old Condition B the term is not defined. "Commercial" is an imprecise word.[7] The epithet "genuine" does not make it any clearer. In New Condition B there is a complex definition which is considered in the next section.

It is submitted that there is no single factor which determines what is "commercial" but a number of factors may indicate one way or the other.

21.5.1 *Transfer with element of bounty*

A transaction made with bounty (gratuitous intent) is not commercial.[8] The concept of bounty (unlike "commercial") is relatively clear. For instance, a gift to a trust for the benefit of the settlor's family is not commercial. The same applies if the class of beneficiaries includes the settlor and the trust is revocable. By contrast, a transfer of assets to a company wholly owned by oneself may be a "commercial transaction" even if the transfer is for less than full (or nil) consideration, and a transfer to an employee trust may be commercial.[9]

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7 *IRC v Plummer* 54 TC 1 at 48: "What exactly is comprehended in the phrase ... 'a bona fide commercial transaction', I do not know" (Viscount Dilhorne). Cf *IRC v Goodwin* 50 TC 583 at 598.

8 *Bulmer v IRC* [1967] Ch 145, citing *IRC v Goodwin* 50 TC 583 at p.607. HMRC adopt this approach in Venture Capital Schemes Manual para 12140:

> "For the EI and CVS, an investor in a company is not eligible for relief unless the subscription is made for bona fide commercial purposes. This rules out any subscription which is motivated by considerations of benevolence. This could be the case if, for example, the company were the proprietor of an unsuccessful professional football club and a supporter of the club paid a large premium for shares in the company; that may well [interestingly, the text formerly said *would clearly*] not be a commercial subscription. Similarly, if the company is owned by a person whom the investor wishes to benefit, and the investor pays a large premium for the shares with the object of increasing the value of the other person's shares, that too would not be a commercial subscription."

Ambrose Bierce makes the same point: "A commercial pursuit is one in which the thing pursued is the dollar." *The Devil's Dictionary* (definition of "Merchant").

9 This is supported by *Wannell v Rothwell* 68 TC 719 at p.733B, a case on loss relief which uses the word "commercial". See too *IRC v Levy* 56 TC 68 at p.87. The issue arose in a case on the meaning of settlement-arrangement. The definition of settlement-arrangement does not include the word "commercial" but the case law "bounty" requirement overlaps with the concept of "commercial".

21.5.2 *Non-business transaction*

In *Carvill v IRC* the Special Commissioner ventured this explanation:

> There was not much difference between the parties about what constituted a bona fide commercial transaction. [Counsel for the taxpayer] contended that this was any genuine transaction which implements or facilitates a business end; [Counsel for HMRC] contended that the transaction must be in furtherance of commerce, ie a trade or business. I shall follow these two meanings.[10]

This seems a fair paraphrase though one should always beware of a paraphrase. At first sight it does not seem to take us very far because the word "business" is notoriously wide and slippery. Nevertheless, one can suggest examples of transactions which should not be classified as commercial because they are not in furtherance of a business. One is the transfer to a trust to avoid the hazards of war, discussed in 21.4 (Enactment history). Another example is a transfer to avoid claims by non-business creditors, e.g. a claim on divorce or forced heirship. These transfers may involve an element of bounty (and may be classified as non-commercial for that reason) but in any event they should be classified as non-commercial transactions because they are not in furtherance of a business purpose.

21.5.3 *Making or managing investments*

In HMRC's view:

> The expression "bona fide commercial" in [Old Condition B] is taken to apply [1] only to the furtherance of trade or business, and [2] not to the making or managing of investments.[11]

10 [2000] STC (SCD) 143 at p.166.

11 RI 201. This was perhaps the view of the drafter of s.703(1) ICTA which refers to transactions:

> "*either* for bona fide commercial reasons *or* in the ordinary course of making or managing investments."

(Emphasis added). But the last 9 words might have been added for the avoidance of doubt, or for some exceptional case, and it is not clear whether the drafter thought that making or managing investments would not usually be commercial.

Proposition [2] (that "commercial" does *not* apply to making or managing investments) is untenable:

(1) The statement does not say what the position is if the making or management of investments constitutes a business. A transfer may be both in the furtherance of a business *and* in the course of making or managing investments.[12] I guess that the intended meaning is, that investment transactions in the course of a business are commercial, but investment transactions which are not in the course of a business are not commercial. This (difficult) concept of business is entirely distinct from the concept of what is commercial.

(2) More fundamentally, making or managing investments *is* generally regarded as "commercial" even if it does not constitute a business. What can be more "commercial" than the management to maximise investment return? This point is recognised in *Lewis v IRC* [1999] STC (SCD) 349 at p.362:

> It is trite law that in exercising their duties trustees must use as much diligence as a prudent man of business ... Faced with the self-investment problem their duty was to act in a business-like manner: this they did. Put another way, they acted commercially as was their duty. In our view it would be construing the statute too narrowly to hold that they did not carry out the transactions for bona fide commercial reasons, unless an investment decision cannot be for commercial reasons.

(3) Section 738(4) ITA assumes that making/managing investments may be "commercial" (in the ordinary sense of the word).

Proposition [1] (that the expression "commercial" applies *only* to the furtherance of trade or business) was put to the Commissioners in *Carvill*, where it obtained some support, see above. Nevertheless, it is too narrow. In practice, commercial transactions will normally further trades or businesses so the issue will not often arise. But there are counter examples, as discussed above: making or managing investments is in

12 Making or managing investments often constitutes a business. For instance, s.105(3) IHTA refers to the business of making or holding investments; s.130 ICTA refers to the business of making investments.

principle a commercial transaction even if it is not in the course of a business.

The most that can be said is that a transaction which is not in furtherance of a trade/business is less likely to be commercial, but this factor is not decisive.

21.5.4 *Commercial from whose viewpoint?*

From whose viewpoint does one assess commerciality? The answer is that it should be looked at from the viewpoint of the transferor, but it would be a rare arrangement under which one party is and the other party is not acting commercially. In *IRC v Willoughby* HMRC accepted that bonds were commercial transactions for Royal Life who issued them but argued that they were not for Professor Willoughby who acquired them. The Special Commissioner did not agree:

> If a contract is entered into by two people and it is a bona fide commercial transaction for one of them, it cannot be not a bona fide commercial transaction for the other party to the contract in the absence of any reason for impeaching the latter's good faith.[13]

The point was not discussed on appeal.

21.6 "Commercial" in New Condition B

Section 738 ITA contains a partial definition of "commercial" for the purposes of New Condition B. The definition is artificial in that it excludes some transactions that are "commercial" in the normal sense of the word. New Condition B is therefore rather narrower than Old Condition B.

Section 738 ITA provides:

> **Meaning of "commercial transaction"**
> (1) For the purposes of section 737, a relevant transaction is a commercial transaction only if it meets the conditions in subsections (2) and (3).
> (2) It must be effected—

13 70 TC at p.86H.

(a) in the course of a trade or business and for its purposes, or
(b) with a view to setting up and commencing a trade or business and for its purposes.

In the following discussion I use the word "business" to mean "trade or business".[14]

At first sight this more or less encapsulates the natural meaning of "commercial". But in fact it is restrictive. An individual may make an investment which is not in the course of a business, e.g. a purchase of a company. This is commercial in the general sense of the word, but it is not "commercial" within the new definition. Section 738(2) thus gives effect to HMRC's proposition [1] of the meaning of "commercial" in Old Condition B.[15]

If a transaction is made between X and Y, it may be in the course of a business of X but not in the course of a business of Y. For example, if Y (an individual) subscribes for shares in X Ltd, an investment company, the issue of shares is in the course of the business of X Ltd. That is sufficient to meet the requirement of s.738(2).

Section 738(4) ITA provides an artificial definition of "trade or business":

> For the purposes of subsection (2), making investments, managing them or making and managing them is a trade or business only so far as—
> (a) the person by whom it is done, and
> (b) the person for whom it is done,
> are persons not connected with each other and are dealing at arm's length.

This subsection is gibberish. First one must identify: (a) "the person *by* whom it is done". "It" must refer to the making or managing of investments. Thus we must identify the person carrying on the business. Next one must identify: (b) "the person *for* whom it (the business) is done". A business is not in normal English "done for" anyone. Presumably the reference is to the customers of the business. For example, if the business is a property business perhaps it is done for the

14 For HMRC views on what constitutes a business, see CG Manual para 65712 and Shares Valuation Manual para 27170.
15 See 21.5.3 (Making or managing investments).

tenants? Is the business of buying and selling shares done for the vendors and purchasers? If one can identify a person within (b), the making/managing of investments is only business "so far as" it is done for unconnected persons. How can something be a business to a limited extent? What if most but not all of the customers are unconnected? While one might, charitably, rewrite the subsection so that it meant that the business must be substantially carried on between unconnected persons, the proper course would be for a court to dismiss it as meaningless.

Section 738(3) ITA provides a further limitation on the meaning of "commercial transaction":

> It must not—
> (a) be on terms other than those that would have been made between persons not connected with each other dealing at arm's length, or
> (b) be a transaction that would not have been entered into between such persons so dealing.

Taken literally, this would exclude an interest free loan to a wholly owned company (even if it is a trading company). Such loans are commercial in the normal sense of the word. One wonders whether that was foreseen by the drafter. EN Draft Clauses (2005) claims that the change merely "clarifies and confirms" the correct interpretation of the existing statute. It is suggested that the provisions should be construed purposively, not literally, so that an interest free loan to a wholly owned company *is* a commercial transaction. Otherwise even dividends are apparently non-commercial transactions, which is absurd.

Suppose T subscribes for shares or debentures in (or make a loan to) an investment company. The transaction satisfies s.738(2) since the company is carrying on a trade or business. The business satisfies s.738(4) provided the business is conducted with third parties: it does not matter that T and the company are connected. The transaction satisfies s.738(3) if it is on arm's length terms.

Is s.738 an *exhaustive* definition of "commercial" or is it merely a partial, exclusory definition? That is, if a transaction meets the express requirements of the section, is it necessarily "commercial" or must the transaction also be "commercial" in the ordinary sense of the word? The wording in s.738(1) ("a ... transaction is a commercial transaction only if ...") could be read as an exhaustive or a partial exclusory definition. It is suggested that s.738 is an exhaustive definition because the legislation is intended to make the law clearer, and a partial definition does not do that. In practice it is difficult to think of a transaction which meets the definition which is not commercial in the ordinary sense of the word, so the issue may not arise.

21.6.1 *Commentary*

When one contemplates the difficulties raised by the statutory definition, one appreciates (as I confess in earlier editions I did not) the wisdom of the 1936 drafter in leaving "commercial" undefined. The word "commercial" is used in many motive defence tests[16] and nowhere else is it defined. It is suggested that the statutory definition of commercial in s.738 ITA should be repealed.

21.7 "Avoidance", "mitigation", "tax reduction", "evasion": introduction[17]

I begin with a fourfold categorisation:

(1) "*Tax evasion*": Conduct which constitutes a criminal offence (fraud on HMRC or similar offences). This normally involves dishonest submission of an incorrect tax return. Dishonesty is essential to the offence.
(2) "*Honest misdeclaration*": The submission of an incorrect tax return without dishonesty. Those involved may be culpable (guilty of neglect or wilful default) but not dishonest.
(3) "*Tax avoidance*": Arrangements that reduce tax liability in a manner contrary to the intention of Parliament (I come later to consider this concept in more detail).
(4) "*Tax mitigation*": Conduct which reduces tax liabilities without "tax avoidance" (not contrary to the intention of Parliament).

The distinctions between these concepts (especially avoidance/evasion and avoidance/mitigation distinctions) are now commonplace. They may appear obvious. They are taught to every student. No policy debate would

16 There are too many to give a full list but the most important are s.138 TCGA; s.685 ITA.

17 For further reading, see Nabil Orow, *General Anti-Avoidance Rules* (Jordans, 2000). This has an extensive bibliography.

be possible without them. However, all four concepts and their associated terminology have only emerged after a gradual process of development and even now the terminology is not always adopted. It is essential to bear this in mind on reading sources on this subject.[18]

For an assessment of subjectivity, morality and judicial criticism of the avoidance/evasion distinction see "Tax Avoidance Purpose and s.741 ICTA" James Kessler [2004] BTR 375 at p.407.

21.7.1 *Avoidance/evasion distinction*

An avoidance/evasion distinction very similar to the present was recognised very early (and was surely self-evident at any time) but at first there was no terminology to express it. In 1860 Turner LJ suggested evasion/contravention (where evasion stood for the lawful side of the divide).[19] In 1900 the distinction was noted as two meanings of the word "evade".[20] The technical use of the words avoidance/evasion in the modern sense originated in the USA where it was well established by the 1920s.[21] It was slow to be accepted in the UK. By the 1950s,

18 e.g. the 1920 Royal Commission on the Income Tax Cmd. 615 discussed evasion, honest mis-declaration and avoidance in one chapter headed "The Prevention of Evasion". In this discussion the words "avoidance" and "evasion" were used quite indiscriminately, see para 625. It is an interesting question whether the absence of terminology hampered a discussion of the issues or whether a lack of discussion or interest led to the absence of suitable terminology. I suggest the latter: in the 1920s, criminal prosecution for tax evasion was rare, and only in blatant cases. Thus the avoidance/evasion distinction was not relevant. Likewise, tax avoidance (in the modern sense) was then still in its infancy so the avoidance/mitigation distinction also had little relevance.

19 *Fisher v Brierly* (1860) 1 de G F&J 643 at 663. It is a pity this terminology did not catch on because it is much more transparent than avoidance/evasion.

20 *Bullivant v AG* [1901] AC 196 at p. 207:

> "The word 'evade' is ambiguous. ... there are two ways of construing the word 'evade': one is, that a person may go to a solicitor and ask him how to keep out of an Act of Parliament – how to do something which does not bring him within the scope of it. That is evading in one sense, but there is nothing illegal in it. The other is, when he goes to his solicitor and says, 'Tell me how to escape from the consequences of the Act of Parliament, although I am brought within it'. That is an act of quite a different character."

21 It is found in the scholarly *Minimising Taxes*, Sears, 1922, Vernon Law Book Co and can be traced to Oliver Wendell Holmes in *Bullen v Wisconsin* (1916) 240 US 625 at p.630. It is regarded as basic in *Tax Avoidance*, Dennis Hartman, Legal Publishing Soc, Washington (1930) which cites two textbook definitions in similar

knowledgeable and careful writers in the UK had come to distinguish the term "tax evasion" from "avoidance/mitigation".[22] A discussion of evasion in the criminal sense is outside the scope of this chapter. It is important for our purposes to note that the term "evasion" was regularly used (by modern standards, misused) in the sense of avoidance, in law reports and elsewhere, at least up to the 1970s.[23] Now that the terminology

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terms. The practice of tax avoidance was more advanced in the USA; the first published work on the subject in England was Jasper Moore, *The Saving of Income Tax Surtax and Death Duties*, Butterworths, 1935 (the publication of which lead to the enactment of the TAA provisions).

22 The 1955 Royal Commission Cmd. 9474 para 1016:
"It is usual to draw a distinction between tax avoidance and tax evasion. The latter denotes all those activities which are responsible for a person not paying the tax that the existing law charges upon his income. *Ex hypothesi* he is in the wrong, though his wrongdoing may range from the making of a deliberately fraudulent return to a mere failure to make his return or to pay his tax at the proper time. By tax avoidance, on the other hand, is understood some act by which a person so arranges his affairs that he is liable to pay less tax than he would have paid but for the arrangement. Thus the situation which he brings about is one in which he is legally in the right, except so far as some special rule may be introduced that puts him in the wrong."
Note that "evasion" is used here (unlike present usage) to describe dishonest criminal evasion and honest mis-declaration. Lord Templeman used this (by then old-fashioned) terminology in *IRC v Challenge Corporation* [1986] STC 548: "Tax evasion occurs when the commissioner is not informed of all the facts relevant to an assessment of tax. Innocent evasion may lead to a re-assessment. Fraudulent evasion may lead to a criminal prosecution as well as re-assessment." It does aid clarity if the term "evasion" is restricted to what Lord Templeman terms "fraudulent evasion".

23 Examples include: *Coutts & Co v IRC* [1963] 2 WLR at p.1418; *Jamieson v CIR* (1963) 41 TC at p.70; *Cory v IRC* [1965] AC at 1107; *Greenberg v IRC* (1971) 47 TC 240 at p.271: "Parliament attempted to prevent this and other methods of tax evasion by provisions in the Finance Act 1960". This usage seems to have stopped in the 1970s; at this time UK economists were giving increasing attention to the subject of tax avoidance and evasion (*Tax Avoision*, p.1, IEA 1979) and perhaps their work had an effect on legal usage. Note that this is purely a semantic and not a substantive point that is being made here. The old usage certainly does not reflect the view that the evasion/avoidance distinction is unreal or unclear or that one can shade into the other. The legal distinction between the two is tolerably clear since evasion involves dishonesty, a tolerably well defined and understood concept. The term "avoision" used in the IEA publication referred to was coined as a convenient term to mean avoidance/evasion. The book noted the lack of *economic* distinction between the two concepts; the economic similarity was the justification for the new coinage. (The book also noted the blurring of a moral distinction between the two

has received official approval in the UK[24] this usage can be condemned as erroneous (but it still happens).[25] But it is sometimes helpful to use the expressions "legal avoidance"[26] and "illegal evasion", to make the meaning clearer.

21.7.2 *Avoidance/mitigation distinction*

The clear[27] articulation of the *concept* of an avoidance/mitigation distinction goes back only to the 1970s[28] and the concept originated from economists, not lawyers. In 1973 C.T. Sandford wrote:

> A government may have one of three attitudes to a particular 'avoidance' measure – using the wide definition of avoidance. It may welcome it; the government may have deliberately offered a tax concession to promote some objective, e.g. tax concessions on mortgage interest, combined with the abolition of Schedule A income tax, in order to encourage owner-occupation; or investment and initial allowances to stimulate new investment in development areas. Second, without having sought positively to encourage a particular 'avoiding' action the government may find it entirely acceptable as when an income tax payer reduces his tax liability by taking a wife or having children; or when a person on retirement transfers savings from a building society to some

concepts either because avoidance was seen by some as immoral or because evasion was seen by some as not immoral; the book did not suggest a lack of a legal distinction which was unquestioned then and still should be now.)

24 *Craven v White* 62 TC 1 at 197; OED 2nd edition (1989) entry under "Taxation."

25 For example, see *R v Charlton* [1996] STC 1418 at 1421. ECJ cases sometimes use "evasion" where avoidance is meant; e.g. *Cadbury Schweppes v IRC* [2006] STC at [50]. This is perhaps due to inadequate translation, or because the EU lawyers do not know the UK distinction.

26 "Legal avoidance" is a standard term in recent double tax conventions.

27 One can find some earlier examples: *Mangin v IRC* [1971] AC 739 is a moderately clear example; the concept is embryonically present in *Newton v Commissioner of Taxation of Australia* [1958] AC 450. But these cases do not draw the line as clearly or quite on the same basis as Sandford and modern cases following him.

28 In 1946, Wrottesley J was unaware of it. Discussing the motive defence, he said: "There cannot, I think, be two opinions as to what 'avoiding' means. Where what is to be avoided is a liability, it must mean to evade, or to keep out of the way of, whether it be as in Richard III, 'The censures of the carping world', or anything else unpleasant that might befall a man, such as a tax": *Congreve v IRC* 30 TC 163. This is describing avoidance in the loose or etymological sense (including mitigation).

> other form of investment in order to reclaim income tax. Third, the government may deplore certain actions as contrary to its intentions; the action is in accord with the letter of the law but not its spirit. *Only actions in this third category should rank as 'avoidance'*.[29]

The use of the terminology avoidance/mitigation to *express* this distinction is an innovation of Lord Templeman in 1986.[30] The expression "tax avoidance" has very often been used in the loose sense, meaning or including mitigation.[31] The reason may be either that the author does not have any avoidance/mitigation distinction in his mind or (if he does) that he is not using the modern terminology to express it. Even now, the term "tax avoidance" is sometimes still used in a loose or etymological sense to include mitigation but nowadays this usage is sometimes jocular, which

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29 *Hidden Costs of Taxation*, IFS, 1973, p.113 (emphasis added). Sandford proposed a second requirement of "avoidance" which he related to the taxpayer rather than to the legislature:

> "It is reasonable to confine 'avoidance' to action which results in the would-be avoiders substantially achieving the objective to which the tax had become an obstacle. Let us give some examples. If a man ceases to buy cigarettes because of tobacco tax he has not achieved his pre-tax objective, i.e. to smoke. Buying sweets instead of cigarettes therefore, is not avoidance. Again, if a taxpayer decides to use most of his wealth for a consumption spree because estate duty makes it not worth while saving for heirs, he is not 'avoiding' for he has abandoned his objective of passing property to heirs. On the other hand, if he reacts to estate duty by making *inter vivos* gifts (assuming he survives for seven years), this is avoidance; it has achieved, though by a more circuitous route, the objective of passing to heirs an intact property."

This is problematic, because there is no obvious way to identify the "objective to which the tax has become an obstacle", and it has not been adopted into the law.

30 *IRC v Challenge* [1986] STC 548. In accordance with the (according to Austin, "childish") declaratory theory of law, Lord Templeman did not say that he was describing a concept relatively new to tax jurisprudence and framing terminology altogether new to describe it. This avoidance/mitigation terminology (although now part of the law of New Zealand and the UK) does not appear to have caught on in America.

31 C.T. Sandford:

> "Amongst tax practitioners the generally accepted definition of avoidance ... is any legal method by which a person can reduce his tax bill... this definition can cover almost anything... I can legally reduce my income tax bill by buying a more expensive house (on which I get additional mortgage interest relief), getting married, having more children, taking out more insurance or simply stopping work."

(*Hidden Costs of Taxation*, IFS, 1973).

suggests that the technical meaning is seeping into public consciousness.[32] Likewise "mitigation" was and sometimes still is used in the sense of "avoidance".[33]

In this book I use the words "avoidance" and "mitigation" in the strict sense. It would be convenient to have a neutral term to describe both avoidance and mitigation (what is described above as the loose etymological sense of "tax avoidance"). There is no agreed term, but "tax reduction",[34] "tax saving", "tax planning" and "tax advantage" might all be used in this sense. It may be less confusing if less elegant to refer to "avoidance/mitigation" where one wishes to refer to the two.

21.8 Meaning of "avoidance" in motive defence

The House of Lords in *IRC Willoughby* decided that "avoidance" in motive defence meant tax avoidance in the strict sense and not mitigation:

> ... it was essential to understand what was meant by "tax avoidance" for the purposes of s 741 ICTA [now Conditions A and B]. Tax avoidance was to be distinguished from tax mitigation. ... My Lords, I am content for my part to adopt these propositions.[35]

This would have surprised those who framed the legislation in 1936/8; they were unaware of any avoidance/mitigation distinction. But the enormously increased complexity of the tax system since 1936 makes the

32 The author once saw an advertisement for PEPs: "Be a tax avoider!" PEPs were a tax free investment now replaced by ISAs. For another example, see *Board of Inland Revenue v Hoe*, A.P. Herbert's *More Uncommon Law,* Methuen, 1982, p.199: "Evidently those who do not smoke or drink are ... avoiding taxation."

33 e.g. C.T. Sandford wrote in 1973 that tax avoidance (in the strict sense) "is often referred to by expressions such as tax planning or tax mitigation": *Hidden Costs of Taxation*, IFS, 1973, p.104. *Craven v White* 62 TC at p,.03 (a requirement of *Furniss v Dawson* is that a transaction "had no other purpose than tax mitigation").

34 See s.748(3) ICTA (Controlled Foreign Companies). INTM208010 (Introduction to the CFC motive test) provides:

> "Despite numerous valiant attempts there has never been a consensus about what is meant by 'tax avoidance' ...
> The CFC motive test attempts to solve the first problem by avoiding any mention of the term 'tax avoidance', settling instead for the rather more neutral concept of a 'reduction in tax' ...".

35 [1997] STC 995 at p.1003.

distinction sensible, perhaps necessary. HMRC accepted that the purchase of an ordinary offshore bond should be taxed under the chargeable event provisions and not under the TAA provisions. One way[36] to reach that result is to give a narrow meaning to tax avoidance and so to widen the motive defence.

21.8.1 *Purpose of tax evasion*

Suppose an individual transfers assets abroad with the dishonest purpose of *evading* UK taxation. Can one apply the avoidance/evasion distinction and say that the individual did not intend to *avoid* taxation, so that – while he may be liable to criminal sanctions – the motive defence applies and excludes the transfer of assets rules? The answer is plainly no. The argument is anachronistic, since in 1936 and for 40 years afterwards, the word "evasion" was used in English jurisprudence to describe avoidance. More fundamentally, the context shows that the expression "tax avoidance" includes (criminal) tax evasion. Any other result would be absurd. This was assumed without argument in *R v Dimsey & Allen* 74 TC 263.

21.9 Meaning of "taxation" in the motive defence

"Taxation" in Old Conditions A and B means any form of UK taxation, and not only income tax: *Sassoon* v *IRC* 25 TC 154. HMRC agree. International Manual provides at INTM600040:

> In this context 'taxation' includes the avoidance of any UK tax liability including for example Inheritance Tax and CGT as well as Income Tax.

Sassoon, though criticised,[37] is a decision of the Court of Appeal and

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36 An alternative, obviously less satisfactory, would be to refuse to recognise the tax purpose of the acquisition, by saying that it is merely incidental, or by applying a *Brebner* or choice principle: see 20.14.1 (A choice principle?). Another solution is to say there is no relevant transfer.

37 For the following reasons:

(1) The rule that an intention to avoid (say) stamp duty should have *income* tax consequences gives rise to obvious anomalies. The usual principle is that each tax must be considered separately. This is the approach usually adopted by anti-avoidance provisions: e.g. s.703 ICTA, or s.137 TCGA. But see

should be taken to represent the law.

For the purposes of New Conditions A and B this rule is now statutory. Section 737(7) ITA provides:

> In this section—
> "revenue" includes taxes, duties and national insurance contributions,
> "taxation" includes[38] any revenue for whose collection and management the Commissioners for Her Majesty's Revenue and Customs are responsible.

Foreign tax is not "taxation" for this purpose. The House of Lords assumed that this was so without argument in *Herdman v IRC* 45 TC 394. This must be right since (1) it is illogical that the purpose of avoiding foreign taxes should have UK tax consequences and (2) it would be almost impossible to apply an avoidance/mitigation distinction to foreign taxes

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s.75(5)(a) FA 1986 for an exception.

(2) Since *Sassoon* was decided, the word "tax" has been given a limited definition. Section 832(3) ICTA (which also applies for the ITA) provides: "Except so far as the context otherwise requires, in the Tax Acts, and in any enactment passed after 12 March 1970 which by any express provision is to be construed as one with the Tax Acts, the Corporation Tax Acts or the Income Tax Acts, 'tax', where neither income tax nor corporation tax is specified, means either of those taxes."
There are two reasons why this statutory change does not affect the position:
    (a) A definition of *tax* does not in principle determine the meaning of the cognate word *taxation*. (Would a definition of "engine" determine the meaning of the cognate word "engineer"?)
    (b) The decision in *Sassoon* was given the implied approval of Parliament in the 1952 consolidation and it is not likely that the 1970 consolidation was intended to alter that.

(3) Section 720(1) ITA refers only to the avoidance of income tax; but see s.721(5)(c) ITA.

(4) Dicta in *Vestey v IRC* 54 TC 503 are said to be inconsistent with *Sassoon*; but this point was not an issue in *Vestey*.

(5) A reversal of *Sassoon* would cut down considerably the multitude of issues that the motive defence currently raises: see 21.21 (Practical examples: introduction).

While of course "context is king", *Sassoon* is supported by consideration of s.22 F(No 2)A 1931 where "taxation" plainly means any tax.

38 This is not an exhaustive definition. At present it is difficult to see what other tax may be caught, but this would be relevant if there was a change in the responsibilities of HMRC (e.g. a new tax was introduced which was managed by a different Government department).

(where the distinction would depend on the foreign tax culture and attitudes).

21.10 Identifying and classifying "purpose": the old conditions

It is considered that the identification of a tax avoidance purpose requires a two-stage approach: identifying and classifying purpose.

21.10.1 *Identify purpose: stage 1*

One must look into the mind of the transferor to ascertain whether his (subjective) purpose was (to use the neutral term) to reduce tax. If he had no purpose to reduce tax then the motive defence applies.

How does one ascertain the transferor's subjective purpose? All facts which may shed light on his purpose must be taken into account. Exemption is not due solely on the basis of an assertion by individuals that tax avoidance was not their subjective intention, because that (self serving) assertion may not be credible in the light of other relevant facts.

It is highly relevant to consider the objective questions:

(1) whether the transfer did reduce tax significantly; and
(2) whether the tax reduction was foreseeable at the time of the transfer.

If the tax reduction was not foreseeable, it is not likely to have been the purpose to achieve it. Conversely the fact that a tax advantage is objectively foreseeable as a consequence of the transfer may be cogent evidence of subjective purpose. We normally have the purpose of achieving the foreseeable consequences of our acts. However, this is not necessarily so. First the transferor may not have foreseen the advantage even though a "reasonable person" might have done so: no-one at all times acts with the foresight of the "reasonable man".[39] Secondly, the transferor may have been aware of (or even have wanted) the advantage but it may nevertheless not properly be classified as his "purpose".[40]

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39 Contrast s.8 Criminal Justice Act 1967, the principle of which is also part of the common law: *Franklin v The Queen* [1987] AC 576.

40 See 21.13 (Foresight and purpose) and 20.14 (Subsidiary consequence not necessarily a purpose).

Before *Willoughby* identifying a purpose of reducing tax was the beginning and end of the matter because an avoidance/mitigation distinction had not been recognised in this context. Now there is a second stage.

21.10.2 *Classifying purpose: stage 2*

If the transferor did have the purpose of reducing tax, one must (applying *Willoughby*) categorise that purpose as "avoidance" or "mitigation". This is determined objectively (in the sense that the issue is independent of the mind of the transferor).

It would be wrong at stage (2) to ask whether the transferor subjectively thought his purpose was "tax avoidance" (as opposed to mitigation) because avoidance/mitigation is a question of law, a decision for the Court and not for him. Indeed, it would generally be pointless, since (unless the individual is a tax lawyer) he will not know the correct meaning of the terms in the present context.

The motive defence therefore involves a mixture of objective and subjective elements, as often happens. (Contrast for instance the question of whether or not there is a trade.)

Stage (1) – the mind of the transferor – is a question of fact, decided by the Tax Tribunal on evidence and the appellate courts have had little to say about it. Anything said on the subject of tax avoidance in motive defence cases before *Willoughby* needs to be reviewed because it will not have considered stage (2).

21.10.3 *HMRC view(s)*

RI 201 states:

> [1] If a transaction involves tax avoidance, that is considered by the Revenue to be at least one of its purposes
> [2] even if the transferor did not form the subjective intention[41] of

41 RI 201 is (I think) using "intention" as a synonym for the statutory word "purpose", but the difficulty of RI 201 becomes more apparent if one disallows that move. It is surely nonsense to say:

> "If a transaction involves tax avoidance, that is considered by the Revenue to be at least one of its purposes even if the transferor did not form the subjective purpose of avoiding tax."

avoiding tax.[42]

This is a rejection of the stage (1) test set out above. In the HMRC view a transfer may have been effected for a tax avoidance purpose even though the transferor did not have the subjective purpose of obtaining a tax reduction. That must be wrong for several reasons. First, the natural meaning of "purpose" is to connote a subjective concept. This meaning is supported by high authority.[43] Of course context may show the word is used in an unusual sense, but that is not the case here. Second, this is the way that the motive defence has always been applied and understood.[44]

While the HMRC statement clearly rejects a subjective purpose test, it is not clear what test HMRC wish to apply instead. What is meant by a transaction "involving" tax avoidance? Sometimes HMRC have argued that the statute requires one to identify the "objective purpose" of the transfer. The attraction of putting the matter this way is that it is close to the wording of the statute. The difficulty is that the expression "objective purpose" is an oxymoron. If that means anything, it means, I think, the purpose which an ordinary reasonable person would have if he had made

42 This is loosely based on a dictum of Lord Nolan in *IRC v Willoughby* [1997] STC 995 at p.1003:

> "Where the taxpayer's chosen course is seen upon examination to involve tax avoidance (as opposed to tax mitigation), it follows that tax avoidance must be at least one of the taxpayer's purposes in adopting that course, whether or not the taxpayer has formed the subjective motive of avoiding tax."

43
> "I shall begin by considering the word 'purpose', for both sides have relied on this word in different senses. Broadly, the appellants contend that it is to be given a subjective meaning and the Crown an objective one.
> I have no doubt that it is subjective. A purpose must exist in the mind. It cannot exist anywhere else."

Chandler v DPP [1964] AC 763 at 804. *Dicta* apparently to the contrary in *Newton v Commissioner of Taxation* [1958] AC 450 at pp.465–6 are rightly criticised and distinguished in John Avery Jones [1983] BTR 22–24. Twenty years later, Avery Jones had the opportunity to make the same point judicially in *Carvill v IRC* [2000] STC (SCD) 143, 75 TC 477. A subjective test also applies for the escape clause in s.703; see *Addy v IRC* 51 TC 71 at p.81E.

44 The drafter of s.33(3) FA 1944 and s.32(3) FA 1951 plainly agreed. This provided (in outline) that where "the main benefit which might have been expected to accrue" from a transaction was tax avoidance, then tax avoidance "was *deemed* to have been the purpose of the transaction". This imposed an objective standard and only makes sense on the assumption that the word "purpose" (in text based on what is now Condition A) was otherwise determined subjectively. The point is made expressly in *Crown Bedding v IRC* 34 TC 107 at p.115.

the same transfer in the circumstances of the transferor. It is difficult to identify purpose in this way because different people may do the same act with different purposes. And which circumstances are relevant? For instance, take the example of the transferor concerned as to the situation in Europe in 1936.[45] His subjective purpose was not tax avoidance. Was his objective purpose tax avoidance? I do not know how to begin to answer the question.

The test that HMRC ultimately wanted to apply is that a transfer has a tax avoidance purpose if it has a tax saving *result*, if its *effect* has been to save tax, or at least if it was reasonably foreseeable that it would do so. This test does make sense (unlike "objective purpose") and it is practical to apply. The difficult with this test is that it is not consistent with the wording of the statute. Purpose and result/effect are two entirely different concepts, and there is no getting away from that.

The ink had hardly dried on the HMRC statement when the Special Commissioners rejected it; *Beneficiary v IRC*,[46] *Carvill v IRC*.[47] Until 2008 HMRC contended that these cases were wrongly decided. However, HMRC sensibly abandoned that position before the Tribunal in *Burns v HMRC*,[48] where the Commissioner said:

> It seems to me to be settled law that what I must address is "purpose", rather than objectively ascertained effect, or presumed effect.

In 2006 I said:

> It is possible that the 2005 changes reflect a (private) understanding by HMRC that their current position is in many cases untenable. In that case it may become easier to obtain clearances for pre-5 December 2005

45 See 21.4 (Enactment history).

46 "We reject counsel's submission that we should look at effect. Purpose is not effect and in our view it is essential to look into the minds of the actors to discover their purpose". But: "The question of whether there was tax avoidance must be looked at objectively". *Beneficiary v IRC* [1999] STC (SCD) 134 at [143].

47 [2000] STC (SCD) 143 at [9]–[13], 75 TC 477 (Special Commissioners). The dictum of Lord Nolan in *IRC v Willoughby* mentioned above which appears to favour an objective approach is, as *Carvill* demonstrates, inconsistent with a long line of authority and has to be ignored (as in *Carvill*) or explained (as in *Beneficiary*).

48 [2009] STC (SCD) 165.

transactions. But there is (of course) no official recognition of this in the published statements and we will have to wait and see.

In practice although the "objective purpose" argument is now (I think) resolved, it has not become any easier to obtain clearances.

21.11 Identifying and classifying purpose: the New Conditions

Old Conditions A and B refer simply (?) to the purpose for which the transactions were effected or designed. New Condition A is that:

> *it would not be reasonable to draw the conclusion, from all the circumstances of the case*, that the purpose of avoiding liability to taxation was the purpose, or one of the purposes, for which the relevant transactions or any of them were effected.

New Condition B is that:

> *it would not be reasonable to draw the conclusion, from all the circumstances of the case*, that any one or more of those transactions was more than incidentally designed for the purpose of avoiding liability to taxation.

The new words are italicised. What difference do they make? Perhaps we should look first to see what HMRC said they intended to achieve:

> 59. The new section 741A ICTA [New Conditions A and B] aims to ensure that all relevant factors are taken into account in deciding whether exemption is due. That is the normal way of applying any purpose test, but in relation to section 741 [Old Conditions A and B] the view is sometimes expressed by tax practitioners that the present test should be interpreted more narrowly. They contend that it is only necessary to look at the subjective intentions of the individual, and that no account need be taken of any other circumstances, even if they included for example the fact that a particular transaction might have been structured in such a way that it directly resulted in a significant tax reduction that was not on the face of it intended by Parliament.
> 60. HMRC has consistently taken the view that such a narrow interpretation of section 741 is not a correct reading of the law. If such an interpretation is accepted, the purpose of the transfer of assets abroad legislation to prevent individuals avoiding income tax in the way defined

> [*sic*] in sections 739 and 740 could not be properly achieved. The new test makes it the condition for exemption that the individual must broadly show that it would not be reasonable to conclude from all the circumstances of the case that any of the transactions had a tax avoidance purpose. The wording of the test is intended to put it beyond doubt that exemption will not be due solely on the basis of an assertion by individuals that tax avoidance was not their subjective intention. Evidence of individuals' subjective intention will be one factor to take into account. However, all other relevant circumstances of the particular case must also be considered, including the actual objective outcome of the transactions.[49]

These paragraphs are somewhat muddled. I think it is making the point made at 21.10.1 (Identify purpose: stage 1). All relevant circumstances must be taken into account in order to identify an individual's purpose. A particularly significant fact is whether the transaction resulted in a significant tax reduction, that is, the actual objective outcome of the transactions.

I have wondered whether the drafter's aim here is something different: to replace the subjective purpose test (which clearly applies to the Old Conditions) with an objective results test. However this is inconsistent with what the EN actually said. Firstly, the current (subjective) test is not the view "sometimes expressed by tax practitioners": it is the view of the two most distinguished Special Commissioners of the day and firmly grounded in the law. Moreover, if it were the intention to substitute a subjective purpose test with an objective results test, then "evidence of individuals' subjective intention" should cease to be "one factor to take into account". It will be completely irrelevant. However, the one thing that is clear is that the passage is unclear. It is unsatisfactory and wrong in principle to try to construe a muddled explanatory note in order to understand a statutory provision. We do not wish to move to the position, sometimes said to apply in the USA, that "if the legislative history is unclear, you read the words of the statute".

Turning, as we must, to the legislation itself, we find that the test still depends on the purpose of the transactions. It is reasonably clear that:

(1) this means the purpose of those who carried out the transactions, and

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49 EN Draft Clauses (2005). The point is made more briefly in EN FB 2006 para 66.

(2) purpose means subjective purpose.

What the new legislation stresses (if only for the avoidance of doubt) is that all the circumstances of the case must be taken into account in order to ascertain the subjective purpose.

Had the drafter sought to replace a purpose test with an objective results test, then he would have used quite different wording, and, indeed, a precedent existed in s.33(3) FA 1944 and s.32(3) FA 1951.

21.12 Transfer made for tax and non-tax purposes

21.12.1 *Condition A*

Condition A depends on whether the purpose of avoiding liability to taxation was the purpose *or one of the purposes* for which the transfer or associated operations were effected.

If one of these purposes is tax avoidance, the transfer fails condition A. It does not matter what the other purposes are.[50]

21.12.2 *Old Condition B*

Old Condition B contains two requirements; both must be satisfied. The first is that the transfer and any associated operations were commercial transactions. Secondly that the transfer and associated operations were not designed for the purpose of avoiding liability to taxation.

What happens if a commercial transaction has two or more purposes? HMRC say in RI 201:

> The Revenue's view is that one of the essential conditions of s 741(b) ICTA would not be satisfied where there was a significant element of tax avoidance purpose in the design of the transfer and any associated operations.

This paraphrase is rather[51] too generous to HMRC. The Special Commissioner stated:

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50 This is stated in *Philippi v IRC* 47 TC 75 at p.110, but it is plain from the terms of the statute.

51 Depending to an extent what nuance one gives to the malleable word "significant".

> One must ask in para (b) whether the transfer was designed for the purpose of avoiding tax or not. This seems to me to require that the main purpose was not tax avoidance because if one has to categorise a transaction as being either designed for the purpose of tax avoidance or not, when it is clearly accepted that a transaction may be designed for more than one purpose, the only way to categorise the design into one purpose is to look at the main purpose of the design. I think, therefore, that the taxpayer's contention of sole purpose is too loose a test and the Revenue's contention of significant purpose is too stringent a test although it will in practice be difficult to determine the difference between a significant and a main purpose.[52]

The point of Condition B is that (if one passes the "commercial" requirement) the "no tax avoidance" requirement is easier to satisfy. Otherwise there is no reason to have two Conditions.

21.12.3 *New Condition B*

The wording has changed in New Condition B. The test is now whether:

> any one or more of those transactions was *more than incidentally* designed for the purpose of avoiding liability to taxation.

This brings the law into line with RI 201.[53] At first I thought (like the Special Commissioner) the difference is relatively slight. But (depending what nuance is given to the malleable word "incidentally") the change does make a difference. Since a merely incidental motive is not likely to amount to a "purpose" at all, a claim which fails Condition A will rarely (if ever) qualify under Condition B. For this reason (and because the "commercial" requirement in New Condition B is so narrow) New Condition B is dead letter law

52 *Carvill v IRC* [2000] STC (SCD) 143 at [89], 75 TC 477. The same Special Commissioner cited and followed this passage in *4Cast v Mitchell* [2005] STC (SCD) 280 at [12].

53 I take "more than incidental" in New Condition B to have the same meaning as "significant" in RI 201.

21.12.4 *Commentary*

Why did Parliament not simply repeal Condition B, rather than amend it out of existence in a way which needs pages to analyse and discuss? Perhaps the full extent of what was done was not realised. Perhaps it was, but it was feared that repeal would raise fiercer objections. However that may be, the rational course would either be to repeal Condition B completely and gain the benefit of simplicity or to return to old Condition B, which had a role to play in aiding commercial life and the economy.

21.13 Foresight and purpose

21.13.1 *Two senses of purpose*

Clause 14(1) of the draft Offences Against the Person Bill (a 1998 Home Office consultation paper) defines intention in a way which illustrates one possible meaning of the word "purpose":

> A person acts *intentionally* with respect to a result if—
> (a) it is his *purpose* to cause it, or
> (b) although it is not his purpose to cause it, he knows that it would occur in the ordinary course of events if he were to succeed in his purpose of causing some other result.

This distinguishes between "intention" and "purpose".[54] Purposes is narrower. If a person has the purpose of causing another result, but knows the tax saving would occur if he succeeds in his purpose of causing the other result, he has the *intention* to obtain the tax saving but not the purpose.

"Purpose" is not always understood this way:

> The word [purpose] can be used to designate either
> [1] the main object which a man wants or hopes to achieve by the contemplated act, or ...

54 Bentham's terminology was direct and oblique intention: *The Principles of Morals & Legislation*, Chapter VIII (Of Intentionality). See M. Cathleen Kaveny's excellent "Inferring Intention from Foresight" 120 LQR 81 and Bratman, Intention, Plans & Practical Reason, Harvard University Press, 1987, Chapter 10 (Intention and expected side effects).

> [2] those objects which he knows will probably be achieved by the act, whether he wants them or not.
>
> I am satisfied that in the criminal law in general, and in this statute in particular, its ordinary sense is the *latter* one.[55]

Here the word "purpose" is understood in the same wider sense as "intention" (as defined above, i.e. foresight does count as purpose) and (I think) "object" is used in the narrower sense.[56]

21.13.2 *"Purpose" in the motive defence*

In RI 201 HMRC say:

> 'Purpose' is taken to be the end it is sought to achieve by the transaction.[57]

This adopts (I think) the narrower concept of purpose and it is suggested that this is correct. Purpose in the motive defence is what a person wants or hopes to achieve (not merely foresight). In practice, the issue arises in Condition A cases.[58]

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55 *Chandler v DPP* [1964] AC 763 at p.804, emphasis added.

56 But elsewhere "object" is said to have the same meaning as "purpose": *Ensign Tankers v Stokes* 64 TC 617 at p.723. These examples neatly illustrate Lord Simon's lament concerning the chaotic terminology in judgments, academic writings and statutes:

> "Will, volition, motive, purpose, object, view, intention, intent, specific intent or intention, wish, desire; necessity, coercion, compulsion, duress–such terms, which do indeed overlap in certain contexts, seem frequently to be used interchangeably, without definition ..."

DPP v Lynch [1975] AC 653 at p.688. See John Avery Jones "The mental element in anti-avoidance legislation" [1983] BTR 22.

57 This is based on *Newton v Commissioner of Taxation of the Commonwealth of Australia* [1958] AC 450 at 465. Note by the way how use of the passive voice ("it is sought to achieve") ducks the issue of whose purpose one is looking for. See George Orwell's essay, "Politics and the English Language".

58 The issue should not arise in a Condition B case (commercial transactions). In a situation where one wanted the commercial transaction, and merely had foresight that a tax saving would follow, even if the tax saving was regarded as *a* purpose (as in the wide *Chandler* sense of purpose) it would not be the main (or significant) purpose.

21.14 Subsidiary consequence not necessarily a purpose

This was stated judicially in the "celebrated"[59] passage in *IRC v Brebner*:

> [1] My Lords, I would only conclude my speech[60] by saying, when the question of carrying out a genuine commercial transaction, as this was, is considered, the fact that there are two ways of carrying it out – one by paying the maximum amount of tax, the other by paying no, or much less, tax – it would be quite wrong, as a *necessary* consequence, to draw the inference that, in adopting the latter course, one of the main objects is, for the purposes of the section, avoidance of tax.
>
> [2] No commercial man in his senses is going to carry out commercial transactions except upon the footing of paying the smallest amount of tax involved.
>
> [3] The question whether in fact one of the main objects was to avoid tax is one for the Special Commissioners to decide upon a consideration of all the relevant evidence before them and the proper inferences to be drawn from that evidence.[61]

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59 *IRC v Willoughby* [1995] STC at [167], 74 TC at [89].

60 For completeness, the TC report reads "judgment" and the AC reads "speech". "Speech" is strictly the correct term.

61 *IRC v Brebner* 43 TC at 718; emphasis original but paragraph numbers added. Another way to read this passage in *Brebner* is to see it as an early recognition of an avoidance/mitigation distinction but that would be anachronistic because the distinction was not then made. It would also be wrong because that distinction is irrelevant in s.703 cases. (This is stated in *Marwood Homes v IRC* [1999] STC (SCD) 44 para 20:

> "Taking steps to obtain relief under s 242 following payment of a dividend outside a group election is clearly within the spirit of the ACT code in the tax legislation. But the fact that a transaction has been carried out to achieve a benefit conferred by a statutory provision will not of itself exclude the application of s 703. This follows from the definition of tax advantage in s 709 which covers both everyday tax planning and transactions, such as traditional dividend stripping, which fall more obviously within the mischief that s 703 was introduced to counteract. The only safeguards available to the taxpayer are the clearance procedures and the escape clause. It cannot therefore avail Marwood to rest its case on the simple proposition that the dividends, ie specified transaction 2 in the present case, were directly within the spirit of s 242."

This does follow from a natural reading of the definition of "Tax advantage" in s.709 ICTA. This term includes a relief from or repayment of tax, as well as the avoidance or reduction of a charge to tax. The concept thus includes both tax avoidance and mitigation.)

The point being made here is not (or not just) that mere foresight of a tax advantage is not a tax avoidance purpose.[62] Lord Upjohn goes further in point [3]: he suggests that where there is a "commercial transaction" knowledge and *choice* of the tax advantageous course over an alternative does not "necessarily" constitute the main purpose or even one of the purposes[63] of the transaction.

At what point does a conscious choice of a tax advantageous course become a tax avoidance purpose in its own right in addition to the commercial purpose? Lord Upjohn does not give an answer to this: to say at [3] that it is a question of fact for the Commissioners, if true, is not exactly helpful.

It is suggested that the test should be: does the tax advantage form an incidental or subsidiary aspect of achieving the commercial transaction (as opposed to being an end in its own right)? If so, there is no tax avoidance purpose. This is an evaluative test which is perhaps easier to state than to apply, but it may sometimes be helpful. It overlaps with an avoidance/mitigation distinction, since an advantage which is judged to be incidental or ancillary to a commercial or family transaction is less likely to be contrary to the intention of Parliament: it is more likely to constitute mitigation than avoidance.

I suggest the point made in *Brebner* is really this: where a transaction is done for a non-tax reason, one should be slower to conclude that another purpose is tax avoidance than in the case of a purely tax motivated transaction. This reflects the reasonable assumption that a purely tax motivated transaction is more likely to be contrary to the intention of Parliament. I refer to this as the *Brebner* principle.

The *Brebner* principle applies not only to commercial transactions, but also to any transaction carried out for primarily non-tax reasons including "ordinary family dealing", which would include most trust transfers, at least those where the settlor is excluded.[64] In practice, this issue arises in

62 The point made at 21.13 (Foresight and purpose).

63 *Brebner* is a case on the transactions in securities motive defence. The wording is not quite the same as Condition A: s.703 ICTA refers to the "main objects" and Condition A refers to "purposes". However, it is considered there is no significant distinction between them. This was presumably the view adopted in *Willoughby* in the Court of Appeal where *Brebner* was cited in a Condition A context.

64 *Mangin v IRC* [1971] AC 739 at p.751 and p.756, restating the *Brebner* principle in the context of an extremely free reading of a New Zealand provision.

Condition A cases.[65] It is considered that the *Brebner* principle continues to apply to New Conditions A and B. It is true that the terms of New Condition B (that incidental purposes are to be disregarded) suggest that incidental purposes in New Condition A are *not* to be disregarded. But the *Brebner* principle is considering matters that are not even "purposes" at all.

21.14.1 *A choice principle?*

The *Brebner* dictum is sometimes regarded as supporting a "choice principle":

> Choosing between two alternatives – if one is carrying out a commercial or a family or an investment transaction, choosing the most tax-efficient – is not avoidance.[66]

But this formulation goes too far: if a UK settlor creates a trust for his family – a family transaction – he has to choose between UK and foreign trustees; but the choice of foreign trustees by the UK settlor is avoidance.[67]

One can accept a choice principle if it is combined with the concept of the intention of Parliament, i.e. if the settlor makes choices within the intention of Parliament, there is no tax avoidance; this is equivalent or very similar to the concept of "special tax regime".[68]

In an earlier edition I suggested a distinction between:

(1) a tax saving which arises because the transfer *is made* (i.e. it would not arise if the transfer had not been made)[69]; and

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65 Because in a commercial transaction, incidental tax avoidance purposes are in any event disregarded.

66 Philip Baker QC "Tax avoidance, tax mitigation and tax evasion", accessible *www.taxbar.com*.

67 It seems that the choice principle has been abandoned in Australia, as a "false dichotomy": see A.J. Myers "Tax avoidance and the High Court since Sir Garfield Barwick" accessible *www.law.unimelb.edu.au/taxgroup/AllanMyers07-04-05Web.pdf*.

68 See 21.16.2 (Special tax regime).

69 Such as the saving of the settlor's own tax liabilities arising from the transfer; see 21.22.1 (No avoidance of settlor's tax liabilities).

(2) a tax saving which arises because the transfer is made *in one particular way* (i.e. it would not arise if the transfer were made in some other way).[70]

This does not work, because classifying a transfer in category (1) or (2) is an arbitrary or evaluative exercise.

21.15 Purpose: advisors and agents of transferor

In a case where a transferor is acting by attorney, the purpose of the attorney should, on normal agency principles, be attributed to the transferor.

In the case where:

(1) a company makes a transfer, and
(2) there is no quasi transferor,[71]

usual company law principles must be applied to attribute to the company the purpose of the individuals acting on its behalf.

If a person relies wholly on advisors (e.g. parents, professionals) and executes documents without more than a vague idea of approving proposals put to him and not properly understood, he has adopted the purpose of his advisors or (which comes to the same thing) the purpose of his advisors is to be attributed to him. In *IRC v Pratt*, Mr. Lucas "did not understand the scheme: it was masterminded by his own professional advisors". Nevertheless, "he, *through his advisors*, was fully acquainted with the fact that what was to follow was a tax avoidance scheme, he must fall fairly within the section".[72]

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70 Such as the saving of the beneficiaries' tax liabilities on a transfer to foreign trustees (which would not arise on a transfer to UK trustees).

71 In such a case of course there would be no *individual* "transferor" who is within s.720: see 18.3.2 (Transfer procured by individual). The purpose of the company which makes the transfer is still relevant for the application of the motive defence to s.731 ITA.

72 57 TC 1 at pp.47, 49. The same point is made in *Burns v HMRC* [2009] STC (SCD)165 at [20] and [39]. The same principle applies for s.703 ICTA; see *Addy v IRC* 51 TC 71 at p.81g. Likewise for the settlement provisions: see 58.25 (Purpose of advisors and agents of settlor). In *Federal Commissioner of Taxation v Consolidated Press Holdings* (2001) 207 CLR 235 the High Court of Australia

For the purposes of New Conditions A and B, s.737(5)(6) ITA provides:

> (5) In determining the purposes for which the relevant transactions or any of them were effected, the intentions and purposes of any person within subsection (6) are to be taken into account.
> (6) A person is within this subsection if, whether or not for consideration, the person—
> (a) designs or effects, or
> (b) provides advice in relation to,
> the relevant transactions or any of them.

This only restates the law applicable to the Old Conditions A and B; it makes no difference to the position.

21.16 Avoidance/mitigation distinction

This section sets out the most important judicial and other statements on the avoidance/mitigation distinction.

21.16.1 *Intention of Parliament*

IRC v Willoughby is now the authoritative general statement on the subject:

> Tax avoidance within the meaning of section 741 ICTA is a course of action designed to conflict with or defeat the evident intention of

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said it was "both possible and appropriate to attribute the purpose of a professional advisor to the taxpayer". I stress this because the opposite view was taken in *Philippi v IRC* 47 TC 75 where the Court of Appeal said at p.114:

> "Young Mr. Philippi ... said that he never had any idea of tax in his mind when he made that transfer. It was true that it was saving him a great deal in UK tax ... but that had not occurred to him; the only reason why he had made the transfer was because his father and other members of the family had told him that he ought to do so. He appears to have had no idea why they gave him that advice. The Commissioners accepted ... his evidence that what he had done he did on his father's advice."

Assuming that this implausible story is true (though "young Mr Philippi" was aged 23 at the time of the transfer) the Court should have held that he had adopted the (tax avoidance) purpose of his father. The point was not argued and *Philippi* should not be followed on this issue.

Parliament.[73]

The Tax Law Review Committee used a similar definition of "avoidance":

> We have regarded tax avoidance as action taken to reduce or defer tax liabilities in ways that Parliament plainly did not intend or could not possibly have intended had the matter been put to it.[74]

HMRC have also adopted this approach:

> Tax avoidance is any action taken to obtain a tax advantage in a way that Parliament did not intend or would not have intended had the matter been put before it. This definition is based upon the report on tax avoidance produced by the Tax Law Review Committee in 1997.[75]

There have been some attempts to be more specific.

21.16.2 *Special tax regime*

Morritt LJ said:

> The genuine application of the taxpayer's money in the acquisition of a species of property for which Parliament has *determined a special tax regime* does not amount to tax avoidance merely on the ground that the taxpayer might have chosen a different application which would have subjected him to less favourable tax treatment.
> (*IRC v Willoughby* [1995] STC at 183, emphasis added)

This repeats the test of the intention of Parliament (what Parliament has "determined" is, I think, the same as what Parliament has intended). It brings the added refinement of identifying the "special tax regime" which Parliament intended to apply. Professor Willoughby's offshore bonds

73 70 TC 57 at p.117.

74 Tax avoidance: A Report by the Tax Law Review Committee (1997) para 1.13, citing *IRC v Willoughby*.

75 IR152 Trusts: An Introduction accessible *www.hmrc.gov.uk/pdfs/ir152.htm*. HMRC have altered the nuance by deleting the words "plainly" and "possibly" from the TLRC formulation, but that does not alter its essential nature.

seem a reasonably clear[76] example of a "species of property for which Parliament had determined a special tax regime".

This category can be generalised into all occasions where Parliament has determined a "special tax regime" (regardless of whether there is any particular "species of property" involved):

> The adoption of a course of action which avoids[77] tax should not fall within section 99 if the legislation, upon its true construction, was intended to give the taxpayer the choice of avoiding it in that way. [78]

The existence of a special relieving regime is neither a necessary not a sufficient condition of tax mitigation. It is only a factor to consider. There is no relieving provision for bed and breakfast transactions, which are accepted as mitigation.[79] Conversely, as the Special Commissioner rightly said in *Carvill v IRC*:

> It is not enough to say that if you find a relieving provision then it is the evident intention of Parliament that the taxpayer should be entitled to use it whatever the circumstances. As *Furniss v. Dawson* [1984] AC 474 shows it is quite possible to mis-use a relieving provision. To give an example in the same area as this case, suppose the Appellant had formed Personal Holdings solely to give him a non-resident employer in order to obtain the foreign emoluments deduction. If that company had been funded entirely by the UK companies and had done nothing other than employ the Appellant, it might be the case that the Appellant would have been avoiding tax because he was misusing a relieving provision. That example of course is deliberately different from the facts of this case where Personal Services was funded from non-UK profits with no corporation tax deduction for services which benefited the UK companies. [Counsel for HMRC] went as far as claiming that Parliament's purpose in enacting the foreign emoluments deduction was to encourage, or at least not discourage, people from abroad to work in the UK so that someone in the Appellant's position who had spent all his

76 Though it might be argued that Parliament had intended the chargeable events regime for normal bonds but not for personal portfolio bonds.

77 Lord Hoffmann has here used "avoid" in the loose etymological sense (to include mitigation). Section 99 provided that an arrangement was void as against the Commissioner for Income Tax if its purpose or effect was "tax avoidance".

78 *O'Neil v Commissioner of Inland Revenue* [2001] STC 742.

79 See 21.16.4 (Other indicia of tax avoidance).

> working life in the UK, could never qualify. While this may have been in Parliament's mind, I cannot accept that the relief was not available to a non-domiciled person working for a non-UK resident employer whose remuneration is borne by a non-resident, however long the non-domiciled person has been resident (I note that the amount of relief was reduced after nine years' residence). ... the taxpayer must do more than point to the existence of a relieving provision; he must be using, rather than misusing, the relieving provision in a way consistent with Parliament's evident intention.[80]

21.16.3 *Economic consequences*

Lord Nolan said in *Willoughby*:

> The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the *economic consequences* that Parliament *intended* to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hallmark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and genuinely suffers the *economic consequences* that Parliament *intended* to be suffered by those taking advantage of the option.[81]

This repeats the test of the intention of Parliament with the added refinement of identifying the intended "economic consequences". This is based on two Templeman judgments:

> The material distinction in the present case is between tax mitigation and tax avoidance ... Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income ...Income tax is avoided ... when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as

80 [2000] STC (SCD) 1543, 75 TC 477, at [91]
81 70 TC at 116 (emphasis added).

> if he had.[82]

The non-recourse loan in *Ensign Tankers* is a clear example of a transaction without economic consequences and in *Challenge* Lord Templeman gave another example which will be particularly relevant to the practical examples considered below:

> When a taxpayer makes a settlement, he deprives himself of the capital which is a source of income and thereby reduces his income. If the settlement is irrevocable and satisfies certain other conditions the reduction in income reduces the assessable income of the taxpayer. The tax advantage results from the reduction of income.[83]

These are transactions with obvious economic consequences.

Professor Willoughby's investment in his bond has some "economic consequences" as compared to a direct investment in the underlying assets though one might have thought they were not very substantial.[84]

Incidentally, one wonders what economists would think of the term "economic consequences". One suspects it is what John Kay derides as "DIY economics".[85]

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82 *IRC v Challenge* [1986] STC 548 cited in *Ensign Tankers v Stokes* [1992] STC at 240. (Lord Millett (whose decision in the High Court was reversed in *Ensign Tankers*) took the opportunity in *Collector of Stamp Revenue v Arrowtown Assets* (Court of Final Appeal of the Hong Kong Special Administrative Region, 4 December 2003) to cast doubt on the correctness of *Ensign Tankers*, but that does not affect the point here.)

83 *IRC v Challenge* [1986] STC at 554–5.

84 Lord Nolan identified the following economic consequences: "The reality in truth is that the bond holder has a contractual right to the benefits promised by the policy, no more and no less. It is therefore quite wrong to describe the bond holder as having, in the words of the Appellants' printed case 'in substance all the advantages of direct personal ownership without the tax disadvantages'. The significance of this misdescription would become all too apparent if—perish the thought—Royal Life were to become insolvent and unable to meet its obligations to the bond holders." Before 2008 I described this as unconvincing, as the insolvency of Royal Life seemed so remote a possibility as to be discounted. But the crash in 2008 shows that Lord Nolan was quite right.

85 See *The Truth About Markets*, John Kay (Allen Lane, 2003). "Economic consequences" is, I suggest, a form *v* substance distinction under a more appealing name. This is a classification and not a criticism. There is nothing necessarily wrong with a form *v* substance distinction if it is recognised for what it is.

21.16.4 *Other indicia of tax avoidance*

It is suggested that "economic consequences" and "special tax regime" are categories of tax saving steps which do accord with the intention of Parliament but are not an exhaustive categorisation of mitigation. They should be regarded as indicia or "badges" of mitigation (like the badges of trade). One can think of others. The Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regs 2004 and 2006 are interesting attempts to identify indicia of tax avoidance for the purposes of disclosure obligations. The indicia include:

(1) confidentiality from other promoters; and
(2) premium fees (typically linked to tax savings).

The OECD also identified secrecy[86] as a common characteristic of avoidance:

> Secrecy may also be a feature of modern avoidance. In some cases tax advisers sell ready-made avoidance devices, one term of the contract of sale being that the taxpayer keeps the facts secret for as long as possible. It is in the interest of the avoiders to keep the administration from learning about new schemes because official and public knowledge may be followed by legislation to counter that kind of avoidance.[87]

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86 There are different types of secrecy:
(1) Secrecy (perhaps better described as confidentiality) against other tax advisers (the scheme vendor wishing to keep the profits of a scheme to himself).
(2) Secrecy against HMRC (as the OECD envisage) in order to postpone the time when HMRC are informed for as long as lawfully possible. There is normally a significant delay between the date of a transaction and the date of any return.
(3) Secrecy against HMRC in order to avoid or frustrate any investigation. Of course dishonest concealment of material facts in breach of a duty of disclosure marks a point where avoidance becomes evasion.

Concealment in category (3) is not primarily characteristic of tax avoidance schemes. It is a problem which may affect all aspects of tax collection (whether or not involving avoidance). The Keith Committee recognised this: Enforcement Powers of Revenue Departments (1983) Cmnd 8822 para 7.3.5. By contrast, lawful concealment in category (1) and (especially) category (2) is an indicia of tax avoidance.

87 OECD Report by Committee of Fiscal Affairs (1980) cited in OECD International Tax Avoidance and Evasion (1987), p.17.

Neither secrecy nor premium fees are normally associated with the practical transactions discussed below. But if, exceptionally, that was the case then it would be a factor suggesting that the transaction should be characterised as tax avoidance.

An important indicia is familiarity and use. Once a tax avoidance arrangement becomes common, it is almost always stopped by new legislation within a few years. If something commonly done is contrary to the intention of Parliament, it is only to be expected that Parliament will stop it. So that which is commonly done and not stopped is not likely to be contrary to the intention of Parliament. It follows that tax reduction arrangements which have been carried on for a long time are unlikely to constitute tax avoidance. There are arguments against this view. It also seems strange that the same act might be stigmatised as tax avoidance if challenged by HMRC or Parliament shortly after it is first done; but if such acts become the general practice over a long period of time then the intention of Parliament is decided differently. Nevertheless, it is submitted that the better view is to have close regard to this factor. Judges have a strong intuitive sense that that which everyone does, and has long done, should not be stigmatised with the pejorative term of "avoidance". This, I suggest, is the true reason why the courts classify bed-and-breakfast transactions and back-to-back loans as mitigation and not tax avoidance.[88] An example in this category is a transfer to an offshore company to avoid IHT, a standard practice since the inception of CTT.

Professor Sandford drew another categorisation of tax savings which offers another indicia of avoidance. He refers to:

(1) Tax savings offered by government to induce a certain kind of behaviour or to fulfill what it feels to be an obligation.

(2) Methods of saving that a government dislikes, but allows to remain for administrative reasons.

(3) Tax savings deriving from technical loopholes unforeseen at the time of drafting.[89]

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88 *Ensign Tankers (Leasing) v Stokes* 64 TC 617 at 739. Back-to-back loans have been accepted by HMRC for decades: International Tax Handbook, para 1201.

89 *Tax Avoision* (1979, IEA) p.81.

Category (1) is obviously mitigation and category (3) is obviously avoidance. It is suggested that category (2) should be classified as mitigation rather than avoidance. An example is a transfer of a land-owning company (instead of its land) to reduce the rate of stamp duty from 4% to 0.5%. The Government considered imposing 4% stamp duty on shares in land-owning companies to prevent this, but decided not to proceed with the idea.[90] Such transfers should be considered mitigation rather than avoidance. This category is particularly important to the practical examples considered below. An example is the use of offshore companies to hold UK assets to save IHT (even though the suggestion to impose IHT on such companies did not reach the level of formal discussion).

21.17 Failed indicia of tax avoidance

21.17.1 *Spirit of the statute*

Other approaches in distinguishing tax avoidance and tax mitigation are to seek to identify "the spirit of the statute" or "misusing" a provision. I take this to mean exactly the same as the "evident intention of Parliament" properly understood. If that is right, the expression adds nothing but rhetoric and confusion. If it means anything vaguer or more intuitive than that, then the concept deserves the ridicule expressed in *Norglen v Reeds Rains Prudential*.[91] Either way, the expression is best avoided in our context.

21.17.2 *Artificial transactions and "devices"*

Another approach is to seek to identify "artificial" transactions. But while tax avoidance frequently involves transactions that can be described as "artificial", this is not always the case. You can have tax avoidance

90 Modernising Stamp Duty (HMRC, Consultative Document 2002) para 2.34. Contrast Australia where the transfer of shares in "land-rich" companies is subject to stamp duty at the rates applicable to land.

91 "It is not that the statute has a penumbral spirit which strikes down devices or strategies designed to avoid its terms or exploit its loopholes. There is no need for such spooky jurisprudence." [1999] 2 AC 1 at 14.

without much (if any) artificiality[92] and, of course, artificiality without tax avoidance. That in itself would not be a fatal objection if we are merely seeking badges of avoidance and not a test which will work every time. However, the unlawyerlike term "artificial" is too vague to be useful even as a badge of tax avoidance. The 1955 Royal Commission on the Taxation of Profits and Income commented on s.44 F(No. 2)A 1915 ("A person shall not, for the purpose of avoiding payment of excess profits duty, enter into any fictitious or artificial transaction ..."):

> A transaction is not well described as 'artificial' if it has valid legal consequences, unless some standard can be set up to establish what is 'natural' for the same purpose. Such standards are not readily discernible.[93]

The Royal Commission is right. The problem is not that the word "artificial" is meaningless. But it can only be used in cases where there are standards of what is non-artificial (or "natural"). For a striking illustration of this truth, see the comment of a MP opposing the proposal in the Married Women's Property Bill 1868, that a married woman should own property, as creating:

> an *artificial* and an unnatural equality between men and women.[94]

The word "artificial" is of no use in marginal cases because there are no such standards. It is of no use in determining whether any of the practical examples considered below are tax avoidance. It represents a conclusion and not a justification. Try it and see.

The same objection applies to that particular obstacle to clear thinking, the term "device".[95]

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92 e.g. an appointment of non-resident trustees or a transfer to a non-resident company.

93 Cmd. 9474 para 1024.

94 Cited in 'Victorian Wives and Property' Lee Holford, in *A Widening Sphere* Ed Vicinus, Methuen, 1980. The proposal did not become law until 1882.

95 *Norglen v Reeds Rains Prudential* [1999] 2 AC 1 at 13: "I do not think that it promotes clarity of thought to use terms like stratagem or device."

21.17.3 *"Genuine"*

The word "genuine" is often used to describe the antithesis to a tax avoidance transaction.[96]

21.18 Intention of Parliament v intention of Government

I suggest two broad approaches to "tax avoidance" can usefully be distinguished:

(1) "Tax avoidance" as politicians, civil servants (and perhaps most non-tax lawyers) use the term. This means a tax reduction arrangement which is contrary to the intention or wish of the *Government of the day* (ministers or civil servants, primarily HMRC). For a revealing example of this usage see the National Audit Office Report (Countering VAT Avoidance, 1992):

> Avoidance involves complex issues and the position is constantly changing. A policy change in the UK, or a ruling from the European Commission or European Court of Justice, can easily result in today's unacceptable avoidance becoming tomorrow's acceptable tax mitigation, and vice versa.

This is "tax avoidance" for the purposes of politics and administration.[97] Likewise the use of A&M trusts, which between 1974 and 2006 was a paradigm example of mitigation, suddenly became tax avoidance in the political vocabulary of the Government of the day.

(2) "Tax avoidance" in the sense used by tax lawyers. This means a tax reduction arrangement which is contrary to the intention of *Parliament*. The view of the Government or HMRC should not come into it.

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96 For example see 21.25 (UK settlor and UK beneficiaries).

97 A purist may say this usage is incorrect or debased; that takes us to the debate as to whether or not there is such a thing as "correct" English usage (where different groups use English differently) and how one determines it if there is. But the purist cannot stop the word being used in this political sense.

This lawyer's concept of "tax avoidance" is better in law because it is consistent with the rule of law: the rule of law requires that tax liabilities are to be determined by settled rules derived from statute and other sources of law, and not by the opinion or decision of a civil servant or politician. This concept is also less volatile. It is right, indeed necessary, for it to be so. If the meaning of "tax avoidance" were "constantly changing" as a result of a mere "policy change in the UK or ruling from the European Commission" then the concept is unworkable for tax.

My distinction is openly accepted in the ITH:

> **103. Avoidance in international context**
> *Within the Revenue we do not categorise avoidance in quite the narrow way that the Courts have done.* Of course we make a distinction between mitigation and avoidance. However, if a taxpayer takes advantage of the law to get a tax advantage which is not, *in our understanding*, within the spirit of the legislation, we tend to look on that as avoidance.
>
> (Emphasis added)

The avoidance/mitigation distinction is not self-explanatory, it is not a given. It is a construct defined and determined by reference to values and attitudes of the tax culture in which we live. The difference between the approaches (1) and (2) is partly: *whose* values and tax culture does one apply, and: *to what materials* does one refer to ascertain these values? The taxation of PETs offers an example. In 1973, C.T. Sandford wrote:

> At present gifts made more than seven years prior to death pay no tax (with the possible exception of capital gains tax). ... Is there evidence that such gifts are contrary to the intention of Parliament? Both circumstantial evidence and logic point to this conclusion. Thus if Parliament were indifferent to the making of gifts prior to death, would there have been successive increases in the gifts *inter vivos* period, which, since 1894, has risen in four successive stages from one to the present seven years?

Sandford considered and dismissed some policy arguments in favour of an estate duty and concluded:

> A reasonable interpretation would be that the gifts *inter vivos* provision

> was intended to prevent as many gifts as possible from circumventing estate duty.[98]

The repeal of CTT and return to an estate duty under the name of Inheritance Tax shows that lifetime giving since 1986 cannot now be regarded as "tax avoidance". I suggest that lifetime giving was not "avoidance" (in the strict sense) of estate duty even in 1973. If Parliament intended to tax all lifetime gifts it would *not* have increased the lifetime gift period to seven years. It is obvious that such an increase would not stop tax-free lifetime giving. Parliament would certainly not have enacted a taper relief under which gifts made more than four years before death pay a reduced rate! How then did Professor Sandford reach the wrong conclusion? Perhaps because he wished to advocate the imposition of a capital transfer tax. When one wishes to support a tax reform, the temptation to describe the old law as permitting "avoidance" is irresistible (as a tool of advocacy) and also has a certain underlying logic. There is tax avoidance in a political if not a lawyer's sense. If some future Government abolishes PETs, and returns to some form of CTT, it seems safe to predict that those supporting the reform will castigate lifetime giving as tax avoidance. One point to note is that a comment from the Government (or any proponent of a tax reform) that existing law permits "avoidance" needs especial scrutiny because it is easy to confuse the intention of Parliament with the intention of Government (or of the proponent).

21.19 How to ascertain "the evident intention of Parliament"?

This is the problem at the heart of the concept of "tax avoidance". If this term means an action contrary to the intention of Parliament, one must identify that intention. C.T. Sandford addressed the problem:

> But here we meet the major difficulty. ... As individuals we may feel certain that a particular action is contrary to the intention of the law; but the *objective* interpretation of that intention can only be found in the words the law uses.[99]

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98 *Hidden Costs of Taxation*, IFS, 1973, p. 113.
99 *Hidden Costs of Taxation*, IFS, 1973, p.114 (emphasis in original).

Sandford was right. The issue is statutory interpretation and the principles of statutory interpretation should be applied. The intention of Parliament should be decided primarily from the words of the statutes. Other material may be relevant on the usual principles of statutory interpretation: White and Green Papers, Royal Commission Reports, Hansard on *Pepper v Hart* principles, textbooks and the occasional learned article.

Lord Nolan refers to the *evident* intention of Parliament. Unless there *is* an "evident" intention, there is no tax avoidance. This qualification does not remove a penumbra of uncertainty, but perhaps it helps to reduce it.

21.19.1 *Two levels of intention*

Now, it may be objected that a concept of "tax avoidance" based on what is contrary to "the intention of Parliament" is not coherent. The object of statutory construction is always said to be to find "the intention of Parliament".[100] A successful tax avoidance scheme, even as blatant a scheme as *Fitzwilliam*,[101] is a scheme where a Court has concluded that the intention of Parliament was not to impose a tax charge in the circumstances which the tax avoiders had placed themselves. A.A. Shenfield made this point:

> What is meant by the intentions of the law and in what sense does avoidance circumvent them? Courts of law in our system seek to find the intention of a law in the words it uses. In this sense the avoider does not circumvent its intentions but abides by them.[102]

The answer is that the expression "intention of Parliament" is being used in two senses. It is perfectly consistent to say that the *Fitzwilliam* scheme:

(1) escapes IHT (there being no provision to impose an IHT charge); and yet
(2) constitutes the avoidance of IHT.

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100 See *Cross on Statutory Interpretation*, 3rd ed., 1995, chapter 2.
101 67 TC 614.
102 A.A. Shenfield, *The Political Economy of Tax Avoidance*, Institute of Economic Affairs, Occasional Paper 24, 1968, pp.20–1.

One is seeking the intention of Parliament at a higher, more generalised level. A statute may fail to impose a tax charge, leaving a gap that even a court cannot fill even by purposive construction, but nevertheless one can conclude that there would have been a tax charge had the point been considered. An example is the notorious case of *Ayrshire Employers Mutual Insurance Association v IRC* 27 TC 331 where the House of Lords held that Parliament had "missed fire".[103] A.A. Shenfield recognised this (perhaps grudgingly):

> What the complainant against avoidance means by the intentions of a law is not what may be deduced from what it says, but what parliament intended it to say, or what parliament ought in the complainant's opinion to have intended it to say, or what in his opinion it would have been equitable for it to say. Now I do not say that this can never have substance. We all know that, quite apart from outright errors of draftsmanship, there is a distinction between the letter and the spirit of a law. But the spirit of a law is elusive. It is tempting to believe that one has grasped the spirit of a law when in truth one is moved by prejudice or preconception. We ought to be extremely careful ...[104]

21.20 Reduction, deferral and unsuccessful avoidance

21.20.1 *Reduction*

The motive defence provisions refer to "avoidance" alone but comparable statutory provisions refer to "avoidance *or reduction*" of tax.[105] In this expression it could be that avoidance is used in the strict sense and

103 It might be objected that this case is wrongly decided by modern standards of statutory interpretation: " I venture respectfully to suggest that if, as in this case, the Courts can identify the target of Parliamentary legislation their proper function is to see that it is hit: not merely to record that it has been missed"; "The Courts as Legislators", Presidential Address of Sir Kenneth Diplock, The Holdsworth Club, 1965 accessible *www.kessler.co.uk*. However, in *Cooper v Billingham* 74 TC 139 para 35 the Court of Appeal was prepared to say that the same result could happen today (albeit rarely).

104 *Ibid*, note 94.

105 The earliest of these was s.35 FA 1941 (Excess Profits Tax); the formula is found in modern provisions: s.775 ICTA and as part of the more lengthy formula in s.709(1) ICTA.

reduction is referring to mitigation, but that is anachronistic (since the distinction was not known at the time). The word "reduction" was probably added to forestall an argument that the mere reduction of tax was not avoidance as long as some tax remained payable.[106] But nowadays a court would not be so literal and there is no doubt that (for the purposes of the motive defence) a reduction of tax from £10 to £6 amounts to the avoidance of £4.

21.20.2 *Deferral*

Arrangements to defer tax may constitute "avoidance".[107] Indeed the classic avoidance case *Furniss v Dawson* might be characterised as involving mere "deferral" of tax. (Of course, the fact that tax is merely deferred, and will or may later be paid, may be a factor which supports the conclusion that the arrangement is to be characterised as mitigation and not avoidance.)

21.20.3 *Unsuccessful avoidance*

The OECD correctly states:

> Successful tax reduction is neither a sufficient nor a necessary test of tax avoidance. It is not sufficient because this would cover acceptable tax planning [i.e. mitigation] and it is not necessary because an avoidance scheme designed to reduce tax may not succeed.[108]

21.21 Practical examples: introduction

We can test these general principles by trying to apply them in some practical cases. There is no test like the test of practice. I first consider transfers to six types of non-resident trust (here called "trust transfers"):

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106 Contrast the statutory expression "mitigate or remit" a penalty.

107 The Special Commissioner so held in *IRC v Willoughby* 70 TC at p.84. There was wisely no appeal on this point.

108 OECD Report by Committee of Fiscal Affairs (1980) cited in OECD's International Tax Avoidance and Evasion (1987), p.17.

(1) Trusts where settlor is excluded:[109]
  - (a) Foreign settlor: UK and foreign beneficiaries;
  - (b) Foreign settlor: only UK beneficiaries;
  - (c) UK settlor: UK beneficiaries;
  - (d) UK settlor: foreign beneficiaries.

("Foreign" here refers to someone not resident or domiciled in the UK and not expecting to become resident or domiciled.)

(2) Trusts where the settlor is a beneficiary:
  - (a) Settlor foreign domiciled but UK resident;
  - (b) Settlor foreign domiciled and non-UK resident.

This by no means covers all the possible circumstances of trust transfers, but one can extrapolate from these to others which may arise.

It may be helpful to summarise the questions that arise on a trust transfer. One must ask: Is the purpose to avoid (1) income tax? (2) CGT? (3) inheritance tax? It is obviously necessary to consider each tax separately; I will consider CGT and IT first, and then IHT. Thus what seemed like a single issue (is there tax avoidance?) raises 3 sub-issues; that is an inevitable consequence of the rule that taxation includes any tax.[110]

However, a tax charge does not arise in isolation, but is charged in different ways on the settlor, trustees[111] or beneficiaries. It is best to consider these three classes of taxpayer separately, though the issues partly overlap. So in the case of a trust transfer one must ask whether the purpose is avoidance of IT/CGT/IHT liabilities of (1) the settlor; (2) the trustees; (3) the beneficiaries. Thus what seemed like only three sub-issues raises nine sub-issues. Further, post-*Willoughby* one must consider whether there is a factual subjective purpose to reduce any of these tax liabilities and then whether the purpose (if present) is to be classified as avoidance or mitigation. So what seemed like a single issue (is the purpose of a trust transfer to avoid taxation?) actually turns out to raise 18 sub-issues (is the

109 It is assumed that the spouse of the settlor is also excluded.

110 See 21.9 (Meaning of "taxation" in the motive defence).

111 Although trustees are in economic reality paying tax on behalf of beneficiaries, the rules for taxation of trustees are distinct from the rules for taxation of beneficiaries so it is best to consider trustees separately.

purpose to save IT/CGT/IHT by settlor/trustees/beneficiaries and, if so, is it mitigation or avoidance?).

21.22 Trust transfers where settlor excluded

Transfers to a trust from which the settlor is excluded have two common features which are relevant for the motive defence:

21.22.1 *No avoidance of settlor's tax liabilities*

The trust transfer will usually bring a tax advantage to the settlor (compared to the position if there is no transfer). As far as the settlor's tax liabilities are concerned, since she is excluded from the trust, any tax advantage she might obtain in this way is mitigation not avoidance. It is not in principle the intention of Parliament that she should pay tax in respect of income/gains/capital from which she is excluded.[112] However, HMRC rightly say that the purpose of a trust transfer may be to avoid tax liabilities of the trustees and beneficiaries and here closer investigation is needed.

21.22.2 *Non-tax reason for creating trust*

There will usually be non-tax reasons for the settlor to make a trust, rather than making absolute gifts. The advantages are asset protection in the broadest sense: protecting the trust fund from profligate beneficiaries, divorcing spouses, and sometimes forced heirship or foreign exchange control. These are good reasons but not commercial ones. So a trust transfer must pass Condition A, not Condition B, but it does so in the context of a transaction which is not usually wholly tax driven. In the absence of tax considerations the usual form would normally be (and in practice generally is) a discretionary trust.

21.23 Foreign settlor; UK and non-UK beneficiaries

This section considers a transfer to a trust whose beneficiaries include (but are not primarily) UK resident and domiciled beneficiaries, and exclude

112 See Lord Templeman's dictum in 21.16.3 (Economic consequences). The exceptional case of s.86 TCGA is discussed below.

the settlor.

21.23.1 *Avoidance of trustees' tax*

In deciding whether the trust transfer yields a tax advantage for the trustees, one obviously cannot compare the actual position (appointment of foreign trustees) with the position if the transfer had not taken place. One must compare it with something else the settlor might have done (which in this context must be the appointment of UK trustees). That seems a reasonable comparable; the settlor has a choice: to transfer to trustees in the UK or elsewhere and he must do one or the other. In the absence of UK tax, there will often be no reason to prefer the one to the other.

The choice of UK trustees (rather than foreign trustees) would not in principle yield any greater CGT before 2007/08.[113] There is no question of CGT avoidance for dispositions before the FA 2006.

The position is slightly more complicated after the FA 2006. The choice of exclusively UK trustees of a discretionary trust will yield CGT (and income tax on foreign source income) not due from non-resident or mixed resident trustees.[114] However, if one trustee (even a minority trustee) is resident outside the UK, the trustees are not (in short) subject to CGT or income tax on foreign income. Does that mean that the choice of non-resident trustees is income tax avoidance? It is submitted that the answer is plainly no. Section 475 ITA assists in the appointment of non-resident trustees, suggesting that this cannot be contrary to the intention of Parliament. To hold otherwise would be to suggest that the settlor has a duty to maximise UK income tax and CGT liability. Any tax saving here must be mitigation. It is relevant to note that the reason for the abolition of the rule that professional trustees should be regarded as non-resident was not to prevent avoidance: it was to satisfy a requirement of EU law.[115]

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113 As long as the UK trustees were professionals: see the fourth edition of this book at 5.8 (Professional trustees treated as non-resident).

114 See 4.4 (Trust residence for income tax and CGT). The IT position for trustees before 1989 was thought by HMRC to be the same, and was held in *Dawson v IRC* 62 TC 301 to be only slightly (and for present purposes not materially) different.

115 HMRC announcement 23 March 2006.

21.23.2 *Avoidance of beneficiaries' income tax liabilities*

In deciding whether the trust transfer yields an income tax advantage for the beneficiaries, one obviously cannot compare the actual position (transfer to trust) with the position if the transfer had not taken place. One must compare it with something else the settlor might have done

The actual position of UK resident and domiciled beneficiaries is that they will pay tax on income distributions from the trust, but no tax on accumulated income and (in the absence of s.731 ITA) no income tax on capital payments. This is a clear income tax advantage if the transfer to a discretionary trust is compared with a transfer to the beneficiaries or to a transfer to an interest in possession trust.

Is the purpose of the transferor to obtain this advantage? Normally his purpose will be to obtain non-tax advantages, and even foresight of the tax advantage may not constitute purpose, but it depends on the facts.[116]

The actual position of UK resident foreign domiciled beneficiaries is that they will pay tax on remitted income distributions from the trust, and (in the absence of s.731 ITA) no income tax on capital payments even if remitted. This could be an income tax advantage if the transfer to a discretionary trust is compared with a transfer to the beneficiaries or to a transfer to an interest in possession trust, but the advantage may be small or nil.

Is the purpose of the transferor to obtain this advantage? Normally his purpose will be to obtain non-tax advantages, and even foresight of this somewhat attenuated tax advantage will not constitute purpose.

21.23.3 *If there is a tax saving purpose is it avoidance or mitigation?*

Returning to the practical example of a transfer to a trust by a foreign settlor, with both UK and foreign beneficiaries. Is the purpose (if it exists) of saving income tax by the beneficiaries to be classified as avoidance? The difference between being a beneficiary of a discretionary trust and owning capital outright is normally[117] a difference with "economic consequences". On an economic consequences test this should be mitigation.

116 See 21.13 (Foresight and purpose).

117 It would be different if the trustees (perhaps guided by a strongly worded letter of wishes) closely follow the wishes of a beneficiary.

There is another indication that the intention of Parliament is not infringed. If s.731 ITA applies, in this class of case, the result is unfair and sometimes extremely unfair. The UK beneficiaries will pay income tax on capital payments on an amount by reference to relevant income which may greatly exceed their "share" of the income of the trust computed on any just and reasonable basis.

If there is avoidance of UK tax there is likely to be avoidance of tax in every other jurisdiction where beneficiaries are resident;[118] it is impossible for the settlor to make a discretionary trust anywhere without tax avoidance elsewhere – which, if not absurd, is somewhat startling.

21.23.4 *Avoidance of beneficiaries' CGT liabilities*

The CGT position is complicated by tax reforms. Before 1998, capital payments from the trust would be free of tax to the beneficiaries (because the usual charge did not apply to a trust with a foreign domiciled settlor). This was expressly set out in s.87 TCGA.[119] One must take that as a special tax regime intended by Parliament. Pre-1998 transfers cannot be regarded as involving CGT avoidance by the beneficiaries.

After 1998, capital payments to UK domiciled beneficiaries give rise to CGT by reference to trust gains regardless of the domicile of the settlor and in 2008 the charge was extended further. This could be taken to suggest that post-1998 transfers constitute CGT avoidance by the beneficiaries. But the points made in relation to IT avoidance/mitigation apply here too. For dispositions before the FA 2006, s.69(2) TCGA is even stronger than it is now. So the better view is that any CGT saving is mitigation.

21.24 Foreign settlor; only UK beneficiaries

The next case to consider is a transfer to a trust whose beneficiaries are all UK resident and domiciled. A trust transfer primarily motivated by non-tax advantages (asset protection) should not normally be regarded as having the purpose of tax reduction.

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118 Assuming they are in a jurisdiction with a tax system comparable to the UK.
119 And in the predecessor legislation: s.17 Capital Gains Tax Act 1979.

In an unusual case, however, that might be one of the settlor's purposes. Indeed, it could be his primary purpose. It can happen be that the settlor creates a trust primarily for a UK beneficiary, and the only reason he does this is tax considerations. Asset protection does not concern every settlor. He would make an absolute gift to a UK beneficiary but for UK tax reasons only he makes a transfer to a trust for his benefit. The transfer is solely UK tax driven.[120]

In these (factually unusual) circumstances the question arises whether the tax saving purpose is avoidance or mitigation. Section 69(2) TCGA and s.475 ITA show the intention of Parliament to be that the choice of foreign trustees by a non-resident and non-domiciled settlor should not be regarded as avoidance of trustees' IT or CGT. These sections apply regardless of the residence and domicile of the beneficiaries. The inference should probably be carried across that there is likewise mitigation not avoidance of beneficiaries' IT and CGT liabilities; but the point is arguable.

21.25 UK settlor and UK beneficiaries

Contrast now a settlor who is UK resident and domiciled, making provision for UK beneficiaries. Assume the settlor is not to be a beneficiary. Again, he will often prefer a trust to outright gifts, for non-tax reasons, and the choice is UK or non-resident trustees. If he chooses the latter, his purpose (or one of his purposes) is likely to be to reduce CGT or Income Tax and this purpose will be tax avoidance rather than mitigation. This is not an invitation to partake in a statutory regime; we all know that this income tax saving is what s.731 is intended to stop.

The distinction is therefore between:

(1) foreign settlors (whose offshore trusts are not in principle regarded as tax avoidance), and
(2) UK settlors (whose offshore trusts are in principle regarded as tax avoidance).

120 This might be made evidentially clear by contemporary correspondence, or if, perhaps, the settlor's gift to a UK child is settled and his gift to other children outside the UK is absolute; but such details only go to identify the settlor's purpose, and are not otherwise significant for tax.

This distinction is clearly drawn in the 1974 Green Paper on Wealth Tax:

> **Overseas trusts**
> 22. Trusts where the trustees are not resident in the UK and the administration of the trust is ordinarily carried on outside this country fall into two broad categories.
> **"Genuine" overseas trusts**
> 23. The first category includes all those trusts set up with non-resident trustees by settlors who have little or no connection with this country. *In such a case even if there are one or more beneficiaries or discretionary objects resident in this country there are no grounds on which it would be right to bring the trustees or the whole of the trust assets within the charge to the tax.* But a UK resident individual with an interest in such a trust, whether in possession or reversion, has a realisable asset which should be included in his personal wealth at its actuarial value. If such a trust is discretionary however its objects generally have no interests in the trust assets on which they should be assessed.
> **"Artificial" overseas trusts**
> 24. The second category includes those trusts where a *UK settlor* arranges for the trustees to be non-resident or where the administration of an existing resident trust passes overseas. The legal ownership of the settled property is thus vested in persons outside UK jurisdiction and *the arrangement is very frequently prompted by tax avoidance considerations*. Accordingly, where settled funds are provided directly or indirectly by a person who at the time the funds were provided was domiciled or ordinarily resident in the UK, the trustees will be liable to the same extent as if the trust had been resident.[121]

While the Paper was addressing the issue of what the Wealth Tax should cover, this passage illustrates very well the general understanding of the concept of tax avoidance in the context of offshore trusts.

Note the terminology of genuine *v.* artificial to describe tax avoidance. The author of the Green Paper had sufficient intellectual rigour to recognise the difficulties in these words and put them in quotation marks accordingly. Would this were done more often![122]

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121 Wealth Tax, Cmnd 5704, 1974 paras 22–4 (emphasis added). The fact that the Wealth Tax proposal was abandoned does not affect the relevance of the passage.

122 See 21.17 (Failed indicia of tax avoidance).

21.26 UK settlor; foreign beneficiaries

Now consider a UK settlor making a trust (from which he is excluded) for foreign beneficiaries.

What about liabilities of the beneficiaries? Since they are not UK resident, they are largely outside the scope of IT and CGT, so there is no avoidance.

In deciding whether the trust transfer yields a tax advantage for the trustees, one can again compare the actual position (appointment of foreign trustees) with the appointment of UK trustees. UK trustees would pay IT if the trust were discretionary but not (for all practical purposes) if it were interest in possession. Any IT saving must be mitigation. CGT is different: UK trustees will pay the tax, and foreign trustees will not. However, trustees are in economic reality paying tax on behalf of the beneficiaries. Where the beneficiaries are not within the scope of the tax then any tax saving by the trustees must be mitigation. This is consistent with the rule that the anti-avoidance provisions of s.87 TCGA and s.731 ITA will not in principle apply on payments to beneficiaries outside the scope of CGT and IT.

21.27 UK settlor; UK and foreign beneficiaries

Where there is a mixture of UK and non-UK beneficiaries I suggest the starting point is that one would expect the settlor to make his trust here, so a transfer to foreign trustees would be regarded as avoidance. (In such a case there is something to be said in income tax terms for the creation of two separate trusts for two separate classes of beneficiaries, the residents and the non-residents, so one at least qualifies for the motive defence. But CGT considerations point the other way.)

21.28 Transfer to trust; settlor a beneficiary

21.28.1 *Foreign domiciled UK resident settlor-beneficiary*

The next case concerns a foreign domiciled UK resident settlor who transfers assets to a non-resident trust under which he is the principal beneficiary.

Income tax is not avoided since trust income continues to be taxed on a remittance basis under s.624 ITTOIA. There may be an IT reduction after the death or exclusion of the settlor but it will not (normally) be the purpose (or even one of the purposes) of the settlor to obtain that (normally very long term) advantage, quite apart from the question of whether the advantage is avoidance or mitigation.

There is in principle a significant CGT advantage and to obtain that advantage is often one of the purposes of the trust. If so, is it CGT "avoidance"? It must have been a decision of Parliament *not* to apply s.86 TCGA to a foreign domiciled settlor and the decision was confirmed in 2008 (where a proposal to extend s.86 to foreign domiciled settlors was contained in FD Draft Clauses (January 2008) and dropped in the Finance Bill.. It is suggested that there is no CGT "avoidance". This is a "statutory invitation" in plain terms.

21.28.2 *Non-resident non-domiciled settlor-beneficiary*

Where the settlor is the principal beneficiary and neither domiciled nor resident then UK tax saving is not likely to be a purpose during the life of the settlor, because no saving in fact arises. After the death of the settlor there may be a saving if there are UK beneficiaries. The position then becomes like that of a trust where the settlor is excluded, and the discussion above is relevant.

21.29 Appointment of non-UK trustees of existing UK trust: purpose of avoiding IT or CGT?

Similar principles apply. One case is where the settlor and beneficiaries are wholly UK based, the settlor has created a UK trust, and foreign trustees are later appointed. The inference that the appointment has the purpose of saving UK income tax or CGT is very strong and this purpose is avoidance not mitigation.

At the other end of the scale is the case where the settlor and the principal beneficiaries have gone to live abroad permanently and local trustees are appointed. One reason for the export of the trust is that the settlor may (or may continue to be) a trustee. If so, the appointment may have no tax saving purpose at all. But if (as is likely) it has a tax saving purpose, that is mitigation and not avoidance.

What if all the beneficiaries are abroad but the settlor remains in the UK? The same tax savings could in principle be had by winding up the trust with outright appointment to beneficiaries, and that transfer is not likely to constitute avoidance. So the appointment of foreign trustees should not be avoidance.

What if the settlor goes abroad and the beneficiaries remain in the UK? It is tentatively suggested that a tax saving purpose (if it exists) is likely to be avoidance.

A more borderline case is where the settlor and beneficiaries go to live abroad for a medium term period (say five years[123]). Non-UK resident trustees are appointed with the intention that the trust will continue to be non-resident even after the settlor returns to the UK. This is probably to be classified as tax avoidance, albeit long-term tax avoidance, but views may differ, especially if the time spent abroad is longer than five years.

21.30 When is a trust transfer made for the purpose of avoiding IHT?[124]

21.30.1 *Change of situs without alteration of ownership*

The transfer of money by a foreign domiciled person from a UK bank to a foreign bank in order to make the money excluded property, is an act of tax mitigation, not avoidance. See *Beneficiary v IRC* [1999] STC (SCD) 134 at p.145. The same would apply if the transfer is made by trustees of a trust with a non-domiciled settlor. The same would apply to a sale of UK situate property and re-investment in non-UK situate property.

21.30.2 *Transfer to trustees*

The residence of trustees is almost wholly irrelevant for IHT.

A gift by a settlor to a trust from which he is excluded is mitigation of his own IHT[125] but it is also necessary to consider the IHT savings of trustees and beneficiaries.

If a foreign domiciled settlor gives, and the trustees retain, non-UK property, any IHT saving purpose which may exist is mitigation. This is so even if the beneficiaries are UK domiciled (so an absolute gift to them would have brought the trust property into the scope of IHT). Section 48

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123 There is no particular significance in selecting five years as illustrative of a medium term period, but it is consistent with the CGT temporary non-residence rules; see 8.1 (Temporary non-residence).

124 For transfers before 27 March 1974 it would be necessary to consider Estate Duty.

125 See 21.22.1 (No avoidance of settlor's tax liabilities).

IHTA provides that foreign property in a trust made by a foreign domiciliary is excluded property. Any IHT advantage conferred by the trust, so far from being contrary to the evident intention of Parliament, would appear to be in accordance with Parliament's evident intention. The argument to the contrary amounts to an argument that the settlor has a duty to maximise IHT liabilities.[126]

A gift by a settlor to a trust from which he is not excluded, in circumstances where the settlor is anticipating becoming UK domiciled, is borderline. Section 48 IHTA makes it plain that such a gift carries substantial IHT advantages. But is it "contrary to the evident intention of Parliament" to enjoy these advantages? The author tentatively suggests that such a gift should be regarded as IHT mitigation not avoidance. This is consistent with the rule (generally though not universally accepted) that the GWR provision does not apply here.[127]

21.31 Transfer of UK assets from non-resident trustees to non-resident trust subsidiary

By "trust subsidiary" I mean a company wholly owned by trustees, which holds beneficially what might in substance be regarded as trust assets.

21.31.1 *Is the transfer a commercial transaction?*

Transfers to trust subsidiaries arise in a wide variety of circumstances and may be made for the purpose of obtaining non-tax advantages:

(1) Advantages of trust administration:
  (a) Segregation of trust funds of trustee (or occasionally combining trust funds) for ease of management.
  (b) Avoiding problems of trustees investing in civil law countries.

(2) In the case of land (or other onerous property), avoiding personal liabilities of trustees arising from direct ownership.

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126 The avoidance/mitigation issue did not arise in connection with the gift t a trust in *Beneficiary v IRC*, because reducing tax was not a purpose in the mind of the transferor/settlor, even though it was a consideration for his advisers, and even though the principal beneficiary was UK resident at the time; see [1999] STC (SCD) 134 at [145h] - [146].

127 See 45.12 (GWR death charge: excluded property rules for settled property).

(3) In the case of interest in possession trusts, to allow retention of income (to avoid distributing income to life tenant).

It is a question of fact in each case whether the purpose of a transfer to a company is to obtain these non-tax advantages and a question of law whether they should be regarded as commercial.

Purpose (1) is commercial: it arises in the ordinary course of managing investments. A transfer from trustees to a company is more often than not a commercial transaction, and for the motive defence one applies Condition B and not Condition A. Purpose (2) is rarer but certainly commercial when it occurs. Purpose (3) is not commercial. Where it is the policy of trustees that all its trust funds should be held in separate wholly owned trust subsidiaries,[128] the conclusion that the transfer has a commercial purpose seems factually likely. But if one is looking at New Condition B, the additional statutory requirements must be met, in particular, the trustees must carry on a business.

21.31.2 *Is the transfer for tax avoidance?*

Transfer of UK assets[129] from trustees to a trust subsidiary may offer significant tax advantages. It is a question of fact whether any of these advantages are purposes of the transfer and a question of law whether the purpose is avoidance or mitigation.

I begin with a case where s.624 ITTOIA does not apply. There are three possible tax advantages:

(1) Obtaining IHT excluded property status (where the settlor was not domiciled in the UK).

128 The Edwards report suggests that 80–90% of Jersey trusts hold their assets through underlying companies: Review of Financial Regulation in the Crown Dependencies Cm 4109 (1998) para 12.5.2 accessible on *www.archive.official-documents.co.uk/document/cm41/4109/4109-i.htm*. Trusts managed in Switzerland generally use underlying companies for Swiss law reasons.

129 Similar considerations apply to a transfer of foreign assets with a view to realisation and re-investment in UK assets.

This should normally[130] be regarded as mitigation. There is of course no economic difference between owning a UK asset directly (non-excluded property) and holding it via a company (effectively converting it into excluded property). But the principle that companies are not transparent for tax purposes is very deep in the tax system. Planning of this kind has been possible since the repeal of the Mortmain Acts (which were enacted to prevent tax avoidance by vesting land in companies) and cannot be regarded as contrary to the intention of Parliament.

The transfer to a company also has a possible CGT disadvantage,[131] and a possible income tax disadvantage,[132] so any tax reduction may be regarded as part of a "package deal", with advantages and disadvantages. This does not savour of tax "avoidance".

The contrary view is taken in *Burns v HMRC* [2009] STC (SCD) 165 at [59]:

> I would certainly accept that if a non-domiciled person arranged to hold foreign situs, rather than UK situs, assets, and then died, no tax advantage would have been sought. Thus if a UK house was sold, and a French house purchased, that would simply be a case of genuinely changing the assets held, and were some section 739 point to hinge on whether the change was effected for the purpose of avoiding UK tax, the answer would be that it was not. And if UK bank deposits were withdrawn and deposits placed elsewhere, then again, that would b a pure investment switch, and not a step the purpose of which would involve the purpose of achieving a UK tax advantage. Indirectly retaining a UK real property, and simply achieving the technical change in status by putting the property into a non-UK resident company in a case where one of the purposes is to achieve the potential Inheritance Tax advantage, implicit by effecting those steps, does seem to me to cross the border between mitigation and tax avoidance. This is because it has involved no real change of investment, as in the two previous examples, but the retention of the UK property, accompanied by a step to change the normal tax consequences of that. Thus where it is shown that the CTT or IHT considerations were one of the purposes of the transfer, or other where the appellants have not displaced the reasonable

130 An exceptional case would be if the property was put in the company shortly before a ten year anniversary and taken out shortly thereafter.

131 Doubling up of trust gains, with serious implications under s.87 TCGA.

132 Loss of tax credits and double taxation relief; sometimes, possible charge under income tax benefit in kind rules.

> presumption that UK advantages were one of the purposes, I conclude that those purposes involve tax avoidance and not merely mitigation.

This is obiter (for on the facts of the case there was clearly avoidance of income tax. The relevant cases and materials are not discussed and the Commissioner has confused tax avoidance with tax advantage. At some time the point will need to be judicially considered in more depth.

(2) Escaping additional rate income tax (on UK source income of discretionary trust).

The striking thing about this tax is that there is generally[133] no effective method for HMRC to collect it and in practice no one expects it to be paid in cases where all the beneficiaries are outside the UK.[134] Perhaps this supports a conclusion of mitigation.

(3) Escaping higher rate income tax (on income of interest in possession trust).

I suggest that a distinction should be drawn between UK resident life tenants (tax advantage is avoidance) and non-residents (tax advantage is mitigation). In many circumstances, however, non-residents do not pay income tax at the higher rate.

In *Burns v HMRC* [2009] STC (SCD) 165 at [58] the Special Commissioner said:

> I deal first with the feature of trying to cap the level of charge to income tax at the basic rate. This advantage seems to me to be in the category of tax avoidance. I entirely accept that, under s.739, tax advantages that have nothing to do with income tax can be the relevant advantages that occasion (of fail to preclude) liability under section 739. In the context of the section, and of the wording in the preamble however, it seems to me to be difficult to argue that a transaction designed to reduce income tax by the mechanism of the transfer of UK property to a non-resident person (virtually a paraphrase of the opening wording of section 739) is mere mitigation.

133 Except in the case of UK land.

134 It is considered that non-payment is not in principle dishonest, and so not a fraud on HMRC, though this conclusion depends to some extent on the facts of the case.

21.31.3 *Transfer by trust to which s.624 applies*

If the purpose of the transfer to a trust subsidiary is to avoid a charge under s.624 ITTOIA, this is considered to be avoidance and not mitigation.

21.31.4 *Transfer of non-UK assets to trust subsidiaries*

When non-UK assets are transferred to a trust subsidiary, the UK tax advantage may be less or nil or there may only be tax disadvantages in the loss of double taxation reliefs. In the absence of an intention to re-invest in the UK the purpose cannot as a matter of fact be a tax reduction purpose.

21.32 Non-resident foreign domiciled individual transfers UK property to offshore company

A foreign domiciled non-UK resident individual who transfers his UK assets to a company incorporated abroad and not UK resident may also enjoy comparable tax advantages:

(1) Obtaining IHT excluded property status.
(2) Avoiding higher rate income tax.

Such transfers also give significant advantages which have nothing to do with tax. In particular, in the case of UK land, avoiding personal liabilities arising from direct ownership. In such cases, the motive defence may well apply. But if a purpose of the transfer is to reduce IHT or IT, this is mitigation not avoidance; the arguments are the same as above.

21.33 Transfer by UK resident foreign domiciled individual to offshore company

Suppose the facts are as in the above paragraph but the transferor is UK resident. If a purpose was to reduce IHT, the transfer is IHT mitigation. A transfer to reduce income tax (because the company pays only basic rate income tax) is considered to be IT avoidance.

A transfer of a non-UK asset to close a source is avoidance if the transferor continues to have power to enjoy the income, but it is mitigation if he is excluded.

21.34 Transfer to UK resident foreign incorporated company

There are many reasons why assets may be transferred to UK resident foreign incorporated companies.

A foreign domiciliary starting a new UK resident company for trade or investment would prefer a non-UK incorporated company so as to own non-UK situate property. This is a commercial transaction and clearly satisfies Old Condition B. New Condition B is (almost) a dead letter,[135] but in an appropriate case there is a reasonable case that New Condition A (or A and B) is satisfied.

A foreign domiciliary (F) wishing to sell a UK unincorporated business may enter into an arrangement under which:

(1) F gives the business to a UK resident foreign incorporated company.
(2) F sells the company (not UK situate property).

If the purpose is to avoid CGT (by utilising s.162 TCGA relief) then the claim for the motive defence is weak.

21.35 Transfer from one trust to another trust

There are many reasons why funds may be transferred between trusts. It is impossible to generalise as to whether such transfers are made for tax avoidance: one must look at the reason for the transfer.

One reason such transfers are made is where a single trust holds several sub-funds for different branches of a family. The transfer avoids the unfairness which arises under a single trust, that gains accruing to one share are taxable on a beneficiary of another share who receives a capital payment. It is considered that a transfer for this reason does not have the motive of CGT "avoidance".

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135 See 21.12.3 (New Condition B).

21.36 Time to ascertain purpose of transferor

What matters is the purpose of the transferor at the time of the transfer.[136] It is quite common that a transfer is made by a foreign settlor for foreign beneficiaries, unimpeachably for non-UK tax reasons, and later some of the beneficiaries move to the UK. Then they will find the trust qualifies for the motive defence and is a useful vehicle for income tax purposes. There are three possibilities:

(1) The change of purpose may be accompanied by a new transfer of assets carried out for a tax avoidance purpose. In that case the transfer of asset provisions may apply in relation to the new transfer.
(2) There may be no further transfer of assets but there may be associated operations carried out for a tax avoidance purpose. The question whether this brings the transfer of asset rules into operation is discussed in para 17.9 (Associated operations).
(3) There may be a change of purpose without any new transfer or associated operation. In that case the motive defence remains available and the transfer of assets provisions do not bite at all.

21.37 Time to ascertain intention of Parliament and changes in law

The concept of tax avoidance as an act contrary to the intention of Parliament raises the question of *at what time* Parliament's intention is to be ascertained. The intention of Parliament may change and the same act could be tax avoidance at one time but not at another. Of course, it needs an Act of Parliament to make this change. For the purpose of the motive defence, tax avoidance must mean an act contrary to the intention of Parliament at the time the transfer took place. This is consistent with the rule that one examines the purpose of the transferor at the time of the transfer.[137] Otherwise changes in the intention of Parliament would often have considerable retrospective effect: a transfer which was not tax avoidance when it was made would retrospectively be treated as made for a tax avoidance motive (or indeed vice versa).

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136 The point was made in *Herdman v IRC* 45 TC 394; but it is plain from the terms of the statute.

137 See 21.36 (Time to ascertain purpose of transfer).

Of course this rule may also favour HMRC. A transfer to avoid (say) Selective Employment Tax would fail the motive defence and that would continue to be the case even after the abolition of that tax.

A distribution or disposal made in 2007/08 to avoid the new rules in the FA 2008 from 2008/09 is not tax avoidance because (1) it is not contrary to the intention of parliament to avoid *future* tax laws: the intention of Parliament is to be determined at the date of the transfer;[138] (2) Parliament clearly anticipated and accepted that such disposals and appointments would be made and took no steps to counteract them.

21.37.1 *Transfer by non-resident before 1996*

Parliament decided in 1936 not to apply s.720 ITA to transfers made by non-resident transferors, and that was (after some vacillation) held to be the law.[139] In principle, a transfer of assets by a non-resident between 1936 and 1996 could not be said to be contrary to the intention of Parliament, and so it could not constitute income tax avoidance.[140] However, the legislation which reversed *Willoughby* and brought transfers by non-residents into the scope of the transfer of asset provisions applies to pre-1996 transfers.[141] The explanation is that a transfer by a non-resident before 1996 does not normally involve income tax avoidance. However, there are special circumstances where a transfer by a non-resident may be for income tax avoidance[142] and, of course, a pre-1996

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138 See 21.37 (Time to anticipate intention of Parliament and changes in law).

139 See 18.5.2 (Transferor not ordinarily resident when transfer made). For convenience, non-resident is used to mean non-ordinarily resident.

140 Contrast pre-1936 transfers by UK resident individuals; these were caught by the new 1936 legislation, but Parliament had never made a decision that such transfers should not be taxed so it would be correct to regard such transfers as made for tax avoidance purposes.

141 s.81 FA 1997. There is an exemption only for income arising before 1996.

142 Examples of special cases are:
(1) a transfer in anticipation of becoming UK resident or
(2) a transfer made just before the enactment of the new legislation (when the change of the law was predictable).

Another view could be that such transfers constitute tax avoidance from after the 1952 and 1970 consolidations, which Parliament enacted on the basis of the *Congreve* and *Herdman* decisions (later reversed) that transfers by non-residents were caught. But that offends common sense and the principle that a consolidation does not alter the law.

transfer made for CGT or IHT avoidance would also be caught.

21.37.2 *Transfer before 1981; transferor having no power to enjoy*

Similar considerations apply to a transfer before 1981 to which s.720 ITA did not apply (because the transferor had no power to enjoy the income of the asset transferred). Parliament decided in 1936 not to apply the transfer of asset provisions to transfers unless the transferor had power to enjoy, and that was (again after some vacillation) held to be the law.[143] So such a transfer should not constitute income tax avoidance. In 1981 Parliament brought in s.731 ITA which applied to pre-1981 transfers.[144] The better view is that a transfer outside s.720 made before the 1981 reforms is not to be regarded as income tax avoidance in the absence of special circumstances. A pre-1981 transfer may be within s.731 where it was made for IT avoidance (one example would be where the settlor did have power to enjoy but later died) or where it was made for CGT or IHT avoidance purposes.

21.38 Associated operations: introduction

The motive defence is relatively straightforward when there is a single transfer. It is more complicated if there are also associated operations to consider. It is necessary to consider separately the cases where:

(1) The associated operation is made before 5 December 2005 (see the next section).
(2) The transfer and the associated operations are all after 4 December 2005.[145]
(3) The transfer is before 5 December 2005 and the operation is on or after that date.[146]

21.39 Associated operations and motive defence before 5 December 2005

The terms of Old Conditions A and B are as follows:

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143 See 15.3 (Meaning of “settlor-interested”).
144 s.45 FA 1981; there is an exception for income arising before 1981.
145 See 21.40 (Transfer and associated operations both after 4 December 2005)
146 See 20.44 (Transfer before and operation on or after 5 December 2005).

> Condition A is that it would not be reasonable to draw the conclusion, from all the circumstances of the case, that the purpose of avoiding liability to taxation was the purpose, or one of the purposes, for which the *relevant transactions* [147] *or any of them* were effected.
> Condition B is that the transfer *and any associated operations*—
> (a) were genuine commercial transactions, and
> (b) were not designed for the purpose of avoiding liability to taxation.

The transfer and any relevant associated operations must each separately satisfy the motive test if the motive defence is to apply. One does not group the transfer and the associated operations together, and look for a single main purpose of the group.

Old Conditions A and B refer to "*any* relevant transactions" or "*any* associated operations". However, prior to 5 December 2005, the reference is to the associated operations that are referred to in s.720 or s.731 ITA. That is, the associated operations relevant to the operation of those sections. Those are the transfer and operations by virtue of which:

(1) (in any case) income accrues to the person abroad; or
(2) (in a s.720 case) the transferor has power to enjoy; or
(3) (in a s.731 case) the individual receives a benefit or income can be used to benefit him.[148]

There may and generally will be other operations associated with the transfer, but those are irrelevant and must be ignored. In *Herdman v IRC* 45 TC 394:

(1) T sold shares to an Irish company (the person abroad) in consideration of an issue of new shares and a loan. This was an innocent transfer (the purpose was to avoid Irish tax).
(2) The company accumulated income. This was (arguably) an operation associated with the transfer, and the purpose was (then) regarded as UK tax avoidance.[149]

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147 For the meaning of "relevant transactions" see 17.10 (Significance of associated operations).

148 See 17.10 (Significance of associated operations).

149 After *Willoughby* the purpose should be regarded as mitigation and not avoidance.

The motive defence was upheld. Lord Reid said:

> [1] It was admitted by Counsel that [what is now s. 720] can only apply if [T] has "by means of" these operations "acquired any rights by virtue of which" he had "power to enjoy" this income during the relevant period. I think that Counsel was clearly right in making this admission.
> [2] I cannot see how it can be said that [T] acquired any rights at all by means of these associated operations. By means of the transfer of the shares to the new company he acquired two rights. He acquired shares in the new company in the Republic and he became an unsecured creditor of that company for over £76,000. Neither right gave him any right in or to particular assets of the new company. The way in which that company dealt with its assets did not alter either of these rights. It may have made them more valuable and it may have made it easier for the company to pay its debts, but it did not change [T's] rights.[150]

Point [1] states the law and point [2] applies the law to the facts. Point [1] needs to be translated to reflect the revised statutory wording, which was recast in 1969, and rewritten in 2007 but the principle has survived.[151] Thus from 1969 to 2006, s.720 only applies if income arises to the person abroad as a result of the associated operation or if the transferor acquired power to enjoy as a result of the operation. I refer to an associated operation which meets these criteria as a "**Herdman-relevant operation**".

In *Carvill v IRC*:[152]

(1) T transferred his majority shareholding in a company to a Bermudian company (B Ltd) in exchange for shares, so T was a majority shareholder in B Ltd ("the original transfer").
(2) T became a 100% shareholder in B Ltd by (a) purchasing shares and (b) B Ltd purchasing its own shares.
(3) B Ltd entered into arrangements to remunerate T via a personal services company and a brokerage sharing agreement.

Steps (2) and (3) were held not to be associated operations, but if they had

150 45 TC at p.413.
151 See 21.40.1 (The 1969 reforms).
152 [2000] STC (SCD) 143 at [80]–[85], 75 TC 477 (Special Commissioners).

been associated operations it would not have mattered as they were not Herdman-relevant operations. No income arose to B Ltd because of the operations and T did not acquire a power to enjoy because of them.[153]

HMRC accept this. RI 201 provides:

> The law was amended in 1969 following a decision of the Courts (in *IRC v Herdman* 45 TC 394) that only the transfer and any associated operations giving a power to enjoy at the outset were relevant for determining whether the terms of [the motive defence] were satisfied. The amendment to the legislation sought to bring all associated operations into consideration when [the motive defence] was invoked. Because of doubts expressed as to the effectiveness of this amendment,[154] it has been the Revenue's practice in considering whether a defence under [the motive defence] is available to *consider only the transfer and any associated operations which directly establish a power to enjoy the income of the overseas person under any particular sub-head in [s 723 ITA].*

The last sentence goes too far and is not to be taken literally. Suppose:

(1) T transfers assets to a UK trust by an innocent transfer, and
(2) Foreign trustees are appointed (an associated operation)[155] for tax avoidance purposes.

It may be said that the associated operation does not establish a power to enjoy the income of the trust. But the associated operation is Herdman-relevant (since it causes income to accrue to the person abroad) so the motive defence does not apply.

Suppose:

(1) T transfers assets to a non-resident company in return for shares in that company ("the first transfer"). Suppose the first transfer is innocent (no tax avoidance purpose). Income accruing to the

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153 See [81]-[83].

154 The "doubts" were in fact expressed in the form of a decision of the Special Commissioners; see 21.40.1 (The 1969 reforms).

155 See 17.11.4 (Transfer to UK trust followed by migration of trust before 6 April 2006) and 17.11.6 (Transfer to company followed by migration of company).

company is not caught by the TAA provisions as the motive defence applies.

(2) T transfers the shares in that non-resident company to a non-resident trust ("the second transfer"). The second transfer has a tax avoidance purpose.

The second transfer is an operation associated with the first. But that associated operation is not Herdman-relevant in relation to the first transfer. Income accrues to the non-resident company as a result of the first transfer. It does not accrue as a result of the first transfer in conjunction with associated operations.[156]

Take the same transactions, but assume that the first transfer had a tax avoidance motive, and the second transfer was innocent. Income of the company is within the TAA provisions. The motive defence does not apply. It is not enough to find an innocent associated operation. Dividends from the company to its shareholders are caught since the income arises by virtue of the tainted transfer to the company and an associated operation (the dividends).

21.40 Transfer and associated operations both after 4 December 2005

21.40.1 *The 1969 reforms*

To understand the post-2005 regime, it is helpful to go back to 1969, when the first attempt at reform was made. Harold Lever (then Financial Secretary to the Treasury) argued:

> If we are to have a section [720 ITA], it has to bite on all settlements abroad which at any time are used for avoidance of tax even though originally started for innocent purpose. Supposing a man has transferred money to set-up a Bible society in Bulowayo and his heir being more sophisticated and perhaps more materialistic, finds himself with a settlement set up for unimpeachable purposes and decides that it would make a useful vehicle for the avoidance of all income tax and surtax. The

156 Of course income arising to the trustees as a result of the second transfer is caught by the TAA provisions. The fact that the first transfer was innocent does not help. This is self-evident but if authority is needed see the decision of the Special Commissioners in *IRC v McGuckian* [1994] STC 900. There was (wisely) no appeal on that point.

> *Herdman* decision meant that section [720] would not prevent this. Clause 27 therefore knocks out the *Herdman* decision and I think that the hon. and learned Gentleman would be fair enough to say that that is reasonable.[157]

The example of a Bulowayo Bible society is facetious (Lever was known for his wit). The common (if less exotic) example is that:

(1) a settlement is set up by a foreign settlor for foreign beneficiaries; and
(2) subsequently beneficiaries come to the UK.

If this was not envisaged at the time of the settlement, even HMRC must concede that condition A was satisfied by the original transfer. Nothing that happened later would alter that defence. So, as Morritt LJ commented (obiter) in *IRC v Willoughby* 70 TC at p.97:

> In the FA 1969, legislation was enacted, s.33, to nullify the [Herdman] decision ... on the point.

However, the Special Commissioners rejected this in an unreported decision.[158] Thus the 1969 Act failed to achieve its intention.

21.40.2 *The 2006 reforms*

HMRC tried again in 2006. Section 737(8) ITA provides:

> If—
> (a) apart from this subsection, an associated operation would not be taken into account for the purposes of this section, and
> (b) the conditions in subsections (2) to (4) [New Conditions A and B] are not met if it is taken into account, because of—
> (i) the associated operation, or
> (ii) the associated operation taken together with any other relevant transactions,
>
> it must be taken into account for those purposes.

157 Hansard, 17 July 1969, cols 955–6.

158 I have been unable to obtain a copy of this decision, though no doubt HMRC have it in their files. If any reader could supply a copy, it would be most helpful to see it.

EN Draft Clauses (2005) explained:

> certain associated operations that might potentially be disregarded when applying the current section 741 [ICTA the motive defence] have to be taken into account for the purposes of the new test. These are associated operations that have an avoidance purpose, but might not directly affect the application of the charging provisions.[159]

A post-4 December 2005 transfer which qualifies for the motive defence loses that defence if:

(1) there is an associated operation;
(2) that operation does not satisfy New Condition A or B.

Trusts and companies which qualify for the motive defence must ensure that from 5 December 2005 any acts by them meet Condition A (or Condition B if relevant). In short, they should do no act which might be regarded as having a tax avoidance purpose. It is important that new associated operations do meet the New Conditions. The transitional rules are harsh.

These conditions are extremely difficult to apply; this may be why almost 40 years passed before the Government made its second attempt to alter the former law. The present Government, it seems fair to say, is unaware or unconcerned about uncertainty and complexity in tax legislation, particularly anti-avoidance legislation.

21.40.3 *Which associated operations count?*

The difficulty with the current law is to identify what counts as "an associated operation" for the purposes of s.737(8) ITA. If the statutory definition is read literally it is far too wide. Suppose in 1096 a Crusader transferred land to trustees to avoid feudal duties, and in 2000 the land is again transferred to trustees. At first sight the 1096 transfer is an

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159 Para 62.The explanation in EN FB 2006 is more curtailed. The provision alters the former law. EN Draft Clauses (2005) claimed (outrageously) that this change was "clarifying and confirming the correct interpretation of the existing statute" but that is scarcely consistent with RI 201 and EN FB 2006 more or less abandoned that position.

operation associated with the 2000 transfer.[160] It cannot be that the Crusader's (arguable)[161] tax avoidance purpose would prevent the transfer in 2000 from qualifying for relief! It is suggested that there must be some connection between the associated operations and the transfer, and the mere fact that they relate to the same property cannot be enough. The position is reminiscent of the Settlement Provisions which define "settlement" as including any disposition, leaving the Courts to devise their own test for what is caught (in that case, the Courts eventually settling on a "bounty" test). Here, it is suggested, the test that the Courts ought to impose should be that the transfer and associated operations form part of one arrangement, or are "put in train" by the transferor.[162]

21.41 When do associated operations have a tax avoidance purpose?

Note the extreme consequences of an associated operation motivated by tax avoidance. Even if the associated operation concerns only a small amount, the *entire* trust may lose the benefit of the motive defence. This unfairness ought to colour the approach of the courts to construing the section.

21.41.1 *Investment strategy*

Buying and selling investments in the ordinary course of managing investments is obviously not tax avoidance.

Suppose trustees wish to invest in UK equities, but do so via a UK unit trust or OEIC in order to hold property which is excluded property for IHT. The transaction is clearly not tax avoidance. It is considered that the position is the same if they chose a non-UK unit trust or OEIC to avoid UK source income.

Suppose a trust, all of whose beneficiaries are abroad, wishes to invest in UK land. The trustees invest via a trust company in order to avoid inheritance tax and the trust rate of income tax on the rent. It is suggested

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160 See 17.9 (Associated operation: definition).

161 Feudal duties would be "taxation"; see 21.9 (Meaning of "taxation"). I forbear to consider the question whether the 1096 transfer should be regarded as avoidance or mitigation of feudal duties (and would that depend on attitudes to taxation in the Middle Ages or contemporary attitudes?).

162 See 17.11.1 (Transfer from A to B followed by transfer from B to person abroad).

that this is mitigation rather than avoidance. If this is not the case, then the effect on the UK economy could be quite remarkable. It would often be the case that well advised trustees would avoid investing in UK land in order to retain the motive defence. On the other hand, if the land was purchased using an artificial SDLT avoidance scheme, that would be caught.

21.41.2 *Distribution strategy*

It is considered that retention of income within a company is not an "operation" but even if it is, it would not be tax avoidance. It is considered that accumulation of income in a common form discretionary trust[163] is not an "operation" but even if it is, it would not be tax avoidance.

Suppose a discretionary trust is within the motive defence. A foreign domiciled beneficiary (not the settlor) is UK resident. If the trustees pay capital to that beneficiary instead of distributing income in order to avoid an IT charge, this is not tax avoidance. If the trustees lend to the beneficiary interest free in order to reduce the amount of a capital payment, this is not tax avoidance. If the loan is at interest, to avoid a capital payment, this is not tax avoidance. An arrangement might be avoidance if trustees lend unsecured to a beneficiary in circumstances where the beneficiary is either insolvent or so lacking in assets that the beneficiary is not in practice ever likely to be able to repay the sum lent.[164]

An arrangement may be avoidance where the trustees accumulate income and then immediately distribute it as capital, in circumstances where the straightforward course would be to distribute as income.[165]

Suppose a discretionary settlor-interested trust is within the motive defence, and the settlor comes to the UK. The trustees retain trust income abroad (if it was remitted to the UK there would be a tax charge under the s.648 clawback). This is not tax avoidance.

Suppose a non-resident company owned by a non-resident individual pays a large dividend the year before the individual becomes UK resident.

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163 A trust to accumulate income with power to distribute. If there were a trust to distribute with power to accumulate, then accumulation would be an "operation".

164 Alternatively the loan in such a case may in fact be categorised as an income distribution.

165 Alternatively the distribution may in fact be categorised as income.

That is not tax avoidance. But if the individual lends the proceeds back to the company, that is a circular and artificial transaction, and the loan may be regarded as for a tax avoidance purpose.

21.41.3 *Inter-group transactions*

For company group transactions, it is useful to refer to the "white list" of transactions which HMRC accept as outside para 2(4A) Sch 7 FA 2003[166] (so they qualify for SDLT group relief). Para 23040 SDLT Manual provides:

> This guidance gives some examples of transactions where it is accepted that group relief is not denied by Para 2(4A) Schedule 7 FA 2003.
> It should be noted that the examples are intended only to give general guidance and do not use technical or statutory language, nor should they be interpreted as if they were a statute.
> They also assume that the transactions described do not form part of any larger scheme or arrangement which might have tax consequences.
> Anyone who wants guidance on a specific transaction is welcome to write to us under the provisions of Code of Practice 10. See SDLTM51000.
> Examples of transactions where group relief is not denied by Para 2(4A) Schedule 7 FA 2003
> (1) The transfer of a property to a group company having in mind the possibility that shares in that company might be sold more than three years after the date of transfer
> (2) The transfer of a property to a group company having in mind the possibility that shares in that company might be sold within three years of the date of transfer, with a consequent claw-back of group relief, in order that any increase in value of the property after the intra- group transfer might be sheltered from stamp duty land tax

166 This provides:

> Group relief is not available if the transaction—
> (a) is not effected for bona fide commercial reasons, or
> (b) forms part of arrangements of which the main purpose, or one of the main purposes, is the avoidance of liability to tax.

"Tax" here means stamp duty, income tax, corporation tax, capital gains tax or [SDLT].

(3) The transfer of property to a group company having in mind the possibility that either (1) or (2) might occur
(4) The transfer of a property to a group company prior to the sale of shares in the transferor company, in order that the property should not pass to the purchaser of the shares
(5) The transfer of property to a group company in order that commercially generated* rental income may be matched with commercially generated losses from a Schedule A business
(6) The transfer of property to a group company in order that commercially generated* chargeable gains may be matched with commercially generated allowable losses
(7) The transfer of property to a non-resident group company in the knowledge that future appreciation or depreciation in value will be outside the scope of corporation tax on chargeable gains
(8) Transactions undertaken as part of a normal commercial securitisation
(9) The transfer of the freehold reversion in a property to a group lessee in order to merge the freehold and the lease, and thus prevent the lease being subject to the wasting assets rules as respects corporation tax on chargeable gains
(10) The transfer of property to a group company in order that interest payable on borrowings from a commercial lender on ordinary commercial terms may be set against commercially generated* rental income
(11) Borrowings on ordinary commercial terms
   (a) from a commercial lender, or
   (b) intra-group in circumstances which would have been commercial had they arisen between unconnected third parties

*Including income, gains and losses which are generated intra-group on transactions which would have been commercial had they been entered into by unconnected third parties

'Transfer' means the transfer of a freehold, in Scotland ownership of land, or the assignment, in Scotland assignation, of a lease.

Cases involving the grant of a lease will need to be considered on their facts.

It is difficult to take point (7) seriously.

21.42 Consequences of tainted operation

Where there is a tainted operation associated with a transfer, all the income of the transfer in principle comes into charge. If there is an innocent transfer of £10m, and a tainted operation of £10,000, all the income of the £10m comes into charge. Section 741 ITA provides a very limited relief:

> (1) Section 742 (partial exemption where later associated operations fail conditions) applies if—
> (a) an individual is liable to tax[167] because of section 720 or 727 for a tax year (the "taxable year") because condition B in section 737(4) (genuine commercial transaction: post-4 December 2005 transactions) is not met, and
> (b) subsections (2) and (3) apply.

The relief only applies for s.720 (and 727) and not for s.731 ITA. Section 741 continues:

> (2) This subsection applies if—
> (a) since the relevant transfer there has been at least one tax year for which the individual was not so liable by reference to the relevant transactions effected before the end of the year, and
> (b) the individual was not so liable for that year because—
> (i) condition B in section 737(4) was met, or
> (ii) condition B in section 739(4) (genuine commercial transaction: pre-5 December 2005 transactions) was met.

The relief only applies if Condition B is satisfied; not if Condition A is satisfied. It has already been noted that New Condition B is hardly ever satisfied. Sections 741 and 742 continue:

> (3) This subsection applies if the income by reference to which the individual is liable to tax for the taxable year is attributable—

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167 "Liable to tax" is defined in s.741(5) ITA:

> "References in this section to a person being liable to tax for a tax year because of section 720 or 727 include references to the individual being so liable had any income been treated as arising to the individual for that year under section 721 or 728."

(a) partly to relevant transactions by reference to which one of those conditions was met for the last exempt tax year, and
(b) partly to associated operations not falling within para (a).
(4) For the purposes of this section a tax year is exempt if—
(a) it is one of the tax years mentioned in subsection (2), and
(b) there is no earlier tax year for which the individual was liable to tax because of section 720 or 727 by reference to the relevant transactions or any of them. ...

742 Partial exemption where later associated operations fail conditions
(1) If this section applies, the individual is liable to tax under this Chapter only in respect of part of the income for which the individual would otherwise be liable.
(2) That part is so much of the income as appears to an officer of Revenue and Customs to be justly and reasonably attributable to the operations mentioned in section 741(3)(b) in all the circumstances of the case.
(3) Those circumstances include how far those operations or any of them directly or indirectly affect—
(a) the nature or amount of any person's income, or
(b) any person's power to enjoy any income.

21.43 Income arising before tainted operation

This section considers how the TAA provisions apply where an innocent post 4-December 2005 transfer is followed by a tainted operation subsequently.

The position where a pre-5 December 2005 transfer is followed by a tainted operation on or after 5 December 2005 raises additional issues discussed at 21.44 (Transfer before and operation on or after 5 December 2005).

21.43.1 *Income before tainted operation: s.720*

Suppose:

(1) an innocent transfer is made on or after 5 December 2005, and
(2) an associated operation made today fails the New Conditions ("the tainted operation").

At first sight *all* income backdated to the date of the transfer comes into charge under s.720 ITA. (In practice HMRC would be limited to a six year period.) HMRC say in a letter dated 7 April 2006 to the representative bodies that only income of the year in the year of the tainted operation and subsequent years is charged. The letter provides:

> **Transitional arrangements, whether income charged retrospectively**
> Representation: It is suggested that the transitional arrangements of [s.740 ITA] have the effect that income could be brought into charge retrospectively. [S.740(4) ITA] could be interpreted as meaning that if an associated operation after 5 December 2005 fails the exemption test in [s.737 ITA], all of the income arising from 5 December 2005 could be charged (even where the subsequent associated operation takes place many years later).
> Response: The legislation does not apply retrospectively in the manner suggested. [s.741C ICTA][168] provides the general rule that section [720] applies in this type of case as it would apply apart from section [736 to 742 ITA]. In those circumstances section [720] would take the income arising in the relevant year of assessment.

This is far from clear in the legislation, but it is a sensible result.

21.43.2 *Income before tainted operation: s.731*

Suppose:

(1) An innocent transfer was made on or after 5 December 2005.
(2) A tainted associated operation is made subsequently.
(3) An individual (not the transferor) receives a benefit in the same year as the associated operation or subsequently.

The beneficiary is taxable under s.731 ITA by reference to all the income which has arisen backdated to the date of the transfer.

Suppose the order of transactions were reversed:

(1) An innocent transfer was made on or after 5 December 2005.

168 Now s.740(3) ITA. The wording is not quite the same, but that has not altered the position.

(2) An individual (not the transferor) receives a benefit on or after 5 December 2005.
(3) A tainted associated operation is made in a tax year after the benefit is received.

That is, the benefit was received in the year before the tax motivated associated operation. Is the benefit retrospectively subject to tax? There is no indication either way but it is suggested that the answer is, no. This is consistent with how HMRC understand s.720 to work.

21.44 Transfer before and operation on or after 5 December 2005

Section 740 ITA provides:

> (1) This section applies if the relevant transactions include both pre-5 December transactions and post-4 December transactions.
> (2) An individual is not liable to tax under this Chapter for the tax year by reference to the relevant transactions if—
> (a) the condition in section 737(2) (exemption where all relevant transactions are post-4 December 2005 transactions) is met by reference to the post-4 December 2005 transactions, and
> (b) the condition in section 739(2) (exemption where all relevant transactions are pre-5 December 2005 transactions) is met by reference to the pre-5 December transactions.

Thus in principle one applies the New Conditions to post-4 December 2005 transactions and the Old Conditions to pre-5 December 2005 transactions.

An important question is whether the motive defence test must be met by:

(1) all associated operations; or
(2) only to *Herdman*-relevant operations (my terminology).[169]

At first s.737(8) ITA appears to answer the question, but it does not, because s.737(1) provides:

169 For the meaning of the expression see 21.39 (Associated operations motive defence before 5 December 2005).

> This section applies if all the relevant transactions are post-4 December transactions.

It is suggested that the *Herdman* principle still applies to pre-5 December 2005 transfers even if the operation takes place subsequently. That is, only *Herdman*-relevant associated operations have to pass the motive test and other associated operations are ignored. This does not deprive s.740 ITA of meaning, for it now governs the position where there are post-4 December 2005 *Herdman*-relevant operations. For instance, if:

(1) there was a transfer to a UK trust (an innocent transfer) before 5 December 2005;
(2) non-resident trustees are appointed (a *Herdman*-relevant association operation) post-4 December 2005.

In deciding whether the motive defence applies one asks whether the relevant associated operation satisfies New Conditions A and B.

The position is not clear cut and HMRC could make the following points:

(1) Section 740(2)(b) incorporates s.737(2) the New Conditions A and B, but by doing so it necessarily incorporates s.737(3) to (7) which supplement s.737(2). So it is possible to say that s.740(2)(b) also incorporates s.737(8).
(2) The transitional rules in s.740, see below, arguably make better sense if s.727(8) is applied. But the rules are so harsh that it is suggested that the taxpayer-favourable construction is to be preferred.

21.44.1 *Transitional rules*

Section 740(3) ITA provides:

> If subsection (2)(b) applies but subsection (2)(a) does not, this Chapter applies with the modifications in subsections (4) to (6).

This brings in three transitional rules where:

(1) the pre-5 December 2005 transactions met the Old Conditions; but
(2) post-4 December 2005 transactions do not meet the New Conditions.

21.44.2 *Transitional rule: s.720*

Section 740(4) ITA provides a transitional rule for section 720:

> For the purposes of sections 720 to 730, any income arising before 5 December 2005 must not be brought into account as income of the person abroad.

HMRC say in a letter dated 7 April 2006 to the representative bodies:

> [Section 740(4) ITA] prevents income arising before 5 December 2005 being chargeable for 2005–06 where an associated operation takes place between 5 December 2005 and 5 April 2006.

Thus this provision was spent when the ITA took effect.

21.44.3 *Transitional rule: s.731*

Section 740(5) ITA provides a transitional rule for s.731 ITA:

> In determining the relevant income of an earlier tax year for the purposes of section 733(1) (see Step 4),[170] it does not matter whether that year was a year for which the individual was not liable under section 731 because of section 739 or this section.

Suppose:

(1) An innocent transfer was made before 5 December 2005.
(2) A tainted associated operation is made on or after 5 December 2005.
(3) An individual (not the transferor) receives a benefit in the same year as the associated operation or subsequently.[171]

The beneficiary is taxable under s.731 ITA by reference to all the relevant income from the date of the transfer (or from 1981, if later). This harshly retrospective rule was actually intended: see EN FB 2006 para 33:

170 See 19.11 (Computation of charge).

171 There is no charge if the benefit is received in a tax year before the operation: see 21.43.2 (Income before tainted operation: s.731).

> [The effect of s.740(5) ITA is:] for the purposes of [s.731 ITA] where the individual receives a benefit in a year of assessment ending after 5 December 2005, the process of determining relevant income under the general rule for years up to and including that year must take account of relevant income that arose in years of assessment ending before that date, as well as later years.

It will often be impossible for the quantum of relevant income to be ascertained exactly, as the records will not exist. But the issue may in practice be fudged by agreement with HMRC.

21.44.4 *Benefit received in or before 2005/06*

Section 740(6)(7) ITA which deal with this were also spent before ITA took effect; see the 6th edition of this book para 19.48.3.

21.45 Motive defence claim in tax return

The motive defence does not require a formal claim.[172] If there has been an innocent transfer, a taxpayer was formerly entitled (indeed required) to complete his tax return on the basis that the motive defence applied; he was not required to prove the motive defence applied to the satisfaction of the Board before completing his tax return on that basis. However, if an individual completes a self assessment return, it has been necessary since the 1998/99 return to indicate on that return that he has taken advantage of the motive defence.[173]

In the 2007/08 tax return, a claim for the motive defence is made by completing box 46 in the Foreign section of the return. The words next to box 46 state:

> If you have omitted income from boxes 11, 13 and 42 because you are claiming an exemption in relation to a transfer of assets, enter the total

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172 See also 17.15 (Disclosure of TAA issues in tax return).

173 RI 201 notes this point:

> "Taxpayers are required to disclose clearly in their self-assessment return if there is any income or benefit assessable under [the TAA provisions], and whether reliance is being placed on [the motive defence] to exclude income or benefit from assessment."

> amount omitted (and give full details in the "Any other information" box) [174]

It is only correct to complete box 46 in a motive defence case. It is not correct to tick the box if the TAA provisions do not apply for some other reason, such as the foreign domicile defence, because that is not an "exemption".[175]

There is strictly no obligation to give precise figures or indeed any figures for the income which (assuming the claim is valid) will not be taxable. However, a failure to give figures will no doubt lead to further enquiries. If estimated figures are given, this should be stated. On the occasion when the claim is first made, sufficient details should be given for HMRC to review the case. Once a claim is agreed, I see no reason to give any details at all in subsequent tax returns. I suggest the words "n/r" be put in box 46 and a note in the additional information section states that since the claim was agreed, no information need be provided as it is irrelevant

Likewise box 42 in the Foreign pages for 2007/08 reads:

> If you have received a benefit from an overseas trust; company or other person abroad, enter the value or payment received

If a foreign domiciled individual received a benefit which is:

(1) not subject to IT (because of the remittance basis); and
(2) not subject to CGT (because of the s.87 remittance basis or because there are no s.2(2) amounts);

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174 The wording is better than that used up to 2005/06, discussed in the 6th edition of this work.

175 The HMRC Foreign Notes show that HMRC take this view:

> "If you have omitted income from boxes 11, 13 and 42 because you are claiming an exemption in relation to a transfer of assets, enter the total amount omitted. The provisions described at boxes 10 to 13 and 42 do not apply if you can show for all the circumstances that the purpose of the transfer and any associated operations was not to avoid tax. But if you omit income for this reason from boxes 11, 13 and 42, you must enter the total amount of income you have omitted in box 46, together with details of the assets transferred and details of the offshore trusts, companies etc. involved in the 'Any other information' box on your Tax Return or on a separate schedule."

then the figure here should be nil but the position (not necessarily the figures) should be disclosed in the additional information section.

21.45.1 *HMRC action when motive defence box is ticked*

RI 201 provides:

> Where such a disclosure has been made and exemption under s 741 ICTA claimed, the Revenue will make any necessary enquiries about that exemption in the statutory period allowed, and will not seek to reopen that year's return on discovery grounds if the s 741 exemption has to be reconsidered in later years.

International Manual at INTM600040 tells Inspectors how to deal with a claim:

> Any claim that [the motive defence] applies should be referred to the Centre for Non-residents, Bootle, Section 739 Group (see INTM600050). Inspectors should not, in any circumstances, offer a view to the taxpayer or agent as to the validity of such a claim. There is no provision for a "clearance" or other advance ruling on the application of [the motive defence]. Claims to [the motive defence] may appear as a tick in Box 6.5A[176] on the Foreign Pages of the Self Assessment Return. The "white spaces" of a return may contain additional information about a [motive defence] claim, or information about a claim may be submitted separately. Such cases should be referred to the Centre for Non-Residents before any decision is taken whether or not to open enquiries under Section 9A TMA 1970.

In practice, expect an enquiry to be opened unless the issue has been resolved in earlier years.

21.46 Dealing with HMRC enquiries

The individual must "satisfy an officer of the Revenue and Customs" that Condition A or B is met.[177] This imposes the burden of proof on the taxpayer. That makes no practical difference as the burden of proof

176 This was the best in years up to and including 2006/07.
177 ss. 737(2), 739(2) ITA.

generally rests on the taxpayer, and in any event, disputes are rarely decided by the burden of proof.[178]

Contemporary correspondence and background documentation may be relevant to the factual issue of whether the transferor had the purpose of reducing tax. It will not shed much light on the issue of whether the purpose should be classified as avoidance or mitigation. Some factors such as confidentiality or tax related agreements may shed light on this, or at least, on whether the parties regarded the matter as tax avoidance.[179] In *IRC v Willoughby* 70 TC 57 for instance, the Special Commissioner reviewed sales literature relating to the offshore bonds. In practice, expect HMRC to ask for contemporary documentation. The advisors should review it before making a claim. In the case of a transfer to a trust, this includes:

(1) Trust documentation and letters of wishes.
(2) If not evident from the above, details of intended beneficiaries.
(3) Details of assets transferred.
(4) Contemporary correspondence between trustees, accountants and settlor. (Legal advice may be privileged.)

Often the issue arises many years after the transfer of assets, and the contemporary records have been lost. That should not matter, as secondary material and inferences from common sense should suffice, but efforts should be made to recover original documentation, if only to avoid the suspicion that damaging documents may have been suppressed.

21.47 Appeals

Section 751 ITA provides:

> **751 The tribunal's' jurisdiction on appeals**
> On any appeal that is notified to the tribunal, the jurisdiction of the tribunal includes jurisdiction to affirm or replace any decision taken by an officer of Revenue and Customs in exercise of the officer's functions under—
> (a) section 737 (exemption: all relevant transactions post-4 December

178 See 2.4.3 (Proof of intention).
179 See 21.16.4 (Other indicia of tax avoidance).

2005 transactions),
(b) section 738 (meaning of "commercial transaction"),
(c) section 739 (exemption: all relevant transactions pre-5 December 2005 transactions),
(d) section 742 (partial exemption where later associated operations fail conditions),
(e) section 743(2) (no duplication of charges: choice of persons in relation to whom income is taken into account).

The wording makes clear that jurisdiction of the tribunal is appellate and not supervisory. The wording of New Conditions A and B ("not be reasonable to draw the conclusion ...") does not impose a *Wednesbury* unreasonableness test.

A decision of the tax tribunal is, on ordinary principles, binding on the parties (subject to an appeal) only in relation to the assessments under appeal. It does not bind the parties in other respects, and in *Carvill v IRC* [2000] STC (SCD) 143, 75 TC 477 a Special Commissioner allowed a motive defence appeal even though a previous appeal relating to earlier years had been decided against the taxpayers. The taxpayers then sought to recover from HMRC the tax paid under the earlier assessments, but this rightly failed. There must be some finality in tax, even when wrong decisions are reached by the courts. See *Carvill v IRC (No. 2)* [2002] STC 1167 and *R (on the application of Carvill) v IRC* [2003] STC 1539. That issue will rarely, if ever, arise again in practice.

A more common problem is where tax has been paid under the TAA provisions for a number of years without consideration being given to the motive defence, and then it occurs to a taxpayer that a motive defence is applicable. It is considered that the principle in *Carvill (No. 2)* only applied where a motive defence had been litigated and decided by the tribunal, and in the absence of litigation on the point it should be possible to put in an error or mistake claim under usual principles.

An appeal will be made by the individual subject to tax (not the trustees or company within s.731 ITA who have no *locus standi*). If the trustees fund an appeal by the individual against assessment under s.731, will that funding constitute a benefit? (If so it will in turn be subject to income tax under s.731 if the appeal is unsuccessful)? The answer depends on the facts. If the reason the trustees fund the appeal is in order to sort out their tax planning for the future, or in order to benefit other beneficiaries, then no taxable benefit is received by the appellant, the benefit is received by all the beneficiaries and there is no rational means of apportionment. At the other extreme, if the trust fund is (more or less) wound up by a capital payment, and the appeal procedure is specifically to benefit one beneficiary, then the trustees financing the appeal would constitute a benefit.[180]

21.48 Can an individual disclaim the motive defence?

An interesting question (which would have surprised those who framed the transfer of asset provisions) is whether it is possible for an individual to disclaim the motive defence. There are at least two circumstances where the application of the TAA provisions may reduce a tax charge:

(1) A UK domiciled and resident beneficiary who receives a capital payment from an offshore trust would until 2008/09 prefer to be taxed under s.731 than under s.87 TCGA, which may apply if s.731 does not, because the IT rates (40%) were lower than the effective CGT rates (64%).
(2) A UK resident transferor who receives a distribution from a non-resident company may be more lightly taxed under s.720: he is taxed on the company's income but has the benefit of tax and tax credits paid by the company, and the distribution is tax free.

It is arguable that the words "the individual satisfies an officer of HMRC" etc., indicate that the benefit of the motive defence can be disclaimed. The individual may choose not to satisfy an officer even though there was no tax avoidance purpose. If the motive defence is compulsory, we would have the absurd result that a transfer for tax avoidance may be less harshly taxed than one which was not.

However, this view would cause considerable difficulties. Suppose a non-resident trust has relevant income of £1m and trust gains of £1m, and capital payments of £1m are made in Year 1 to beneficiary A and in Year 2 to beneficiary B. A and B are both resident and domiciled in the UK. Suppose the trust is in principle within the motive defence because the transfer to it was not for tax avoidance purposes. Before 2008/09 A would probably wish to disclaim the motive defence, if he could, so the capital

180 Or else it may be subject to CGT as a capital payment.

payment to him was subject to income tax, and he avoided the s.87 interest surcharge. However, it would be in the interest of B to argue that the motive defence did apply, so that the payment to A "washed" the capital gain and the payment to B was tax free. It is evident that the offshore trust rules simply do not work if the motive defence can be disclaimed by one beneficiary and claimed by another. Nor do they work fairly if it can be disclaimed by one beneficiary in a manner which binds all the others. So the better view is thought to be that the motive defence (if applicable on the facts) is compulsory and binds all the beneficiaries.

21.49 Motive defence: commentary

The reader who studies this long and difficult chapter will almost certainly agree with the author that the 2006 reforms were wrong headed in policy though clumsy drafting adds its mite to the confusion.

What should be done? The best solution would be to return to the (relatively) simple pre-2006 position.

CHAPTER TWENTY TWO

LIFE POLICIES AND CONTRACTS ("BONDS")

22.1 Policies – Introduction

This chapter considers:

(1) policies of life insurance,
(2) life annuity contracts, and
(3) capital redemption policies.

I refer to these as "**policies and contracts**". This is the terminology generally used in the legislation. Where possible I abbreviate the expression to "policies". The asset is often described in the insurance industry as a bond; statute has adopted that term in the expressions "personal portfolio bond" and "guaranteed income bond". Strictly the term "bond" is wider, meaning any obligation undertaken by deed.

Policies fall within Chapter 9 Part 4 ITTOIA, sometimes called the "chargeable event" regime. This contains almost 100 sections and is, I think, the longest chapter in ITTOIA. The reader will not be surprised if I say that the subject needs a long book to itself.

The provisions are sometimes very crude. Partial surrender is a particular trap.[1] This is the only place I have seen in the HMRC Manuals where districts are warned "not to attempt any discussion or explanation as to the equity of the treatment for tax".[2]

It is common to structure an investment in the form of a life insurance policy (with only a nominal element of life insurance). So one can

1 In practice this is avoided by life companies issuing a cluster of separate policies, instead of one single policy.

2 Assessment Procedures Manual para 3147a.

effectively opt into the chargeable event regime by choosing to invest in a policy rather than in some other form. This is popularly called a life insurance wrapper.

On situs for IHT see 59.17 (Insurance policy); on situs for CGT see 60.15 (Insurance policy).

The taxation of policies held by UK resident companies is not discussed here.

22.2 Policies – definitions

22.2.1 *Meaning of "life insurance"*

The definition of life insurance needs a long chapter to itself. IPT Manual provides:

> **1115. Fundamental concepts: what is a life policy?**
> According to the 1774 Life Assurance Act, a policy of life insurance is an insurance policy on life. There is no further definition in the Taxes Acts. If a policy pays benefits on the death of an individual, either whenever it happens, or within a specified term, then it is potentially within the scope of the chargeable event legislation.
> It is not relevant for tax purposes that such a policy may also provide insurance against other risks, such as disability and critical illness, although that might affect its regulatory or accounting treatment.
> But funeral plan contracts where a customer pays a sum to a funeral provider to provide a funeral in due course are specifically excluded by Financial Services Authority regulations from being life insurance, or indeed a contract of insurance generally.
> The word policy in connection with insurance has a long history. It is the formal document in which an insurer (that is, insurance company or friendly society) sets out the terms of its obligations in consideration of the stipulated premiums. For an insurance contract to be made, or varied, between an insurer and policyholder requires the completion of the standard contract law offer and acceptance. There is no practical distinction between contract and policy; the latter simply evidences the former. Lord Donaldson confirmed this in the judgment referred to at IPTM1110.

There is also an interesting discussion in the General Insurance Manual para 1010, which is not set out here for reason of space.

22.2.2 *Meaning of "capital redemption policy"*

A full discussion of the term (defined in s.473(2) ITTOIA) is not attempted here. IPT Manual provides:

> **1120. Fundamental concepts: what is a capital redemption policy?**
> Capital redemption policies, though issued by insurance companies, are not strictly speaking insurance products. They were once known as investment bond contracts, which is more descriptive but needs to be distinguished from the type of life policy investment bond described at IPTM1100. Under capital redemption policies, one or more fixed sums is paid to an insurer under a contract pursuant to which one or more specified amounts is paid out at some later time or times, on the basis of an actuarial calculation. Typically the contracts take the form of
> - an annuity certain, where a capital sum is used to buy an annuity for a fixed term not contingent on life, see IPTM4200, or
> - a sinking fund where regular sums are paid in to secure a capital sum at some later date, for example against the need to find a premium payment to renew a lease.
>
> The statutory definition of capital redemption business is at Section 458(3) ICTA 1988. Contracts within such business are long term insurance business but not life business. A capital redemption policy that creates a debtor/creditor relationship, with an agreement to return the sum advanced, is known as a capital redemption bond and is similar in nature to a relevant or deeply discounted security, see IM1520. However, such bonds, which may only be sold by an insurer, are removed from the scope of the deeply discounted securities income tax charge of Section 427 ITTOIA onwards.[3]

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3 See too the explanatory notes to the draft legislation published in the Pre-Budget Report, 5 December 2005:

> 15. A capital redemption policy is a contract, issued by an insurer, which is made in the course of capital redemption business. Under a capital redemption policy, for consideration of a sum or sums of money, the issuer of the policy guarantees to pay out a larger sum on a specified future date or to make a series of payments. Payment is independent of any contingency linked to human life.
>
> Examples of such contracts include—
> - an annuity certain - an annuity payable for a set period not contingent upon the survival of a life,
> - a leasehold redemption policy - which builds up a fund to be used in some way on the expiry of a lease, and
> - a sinking fund policy - this accumulates a fund for the eventual replacement of a wasting asset.

22.2.3 *Meaning of "annuity"*

A full discussion of the term "life annuity" (defined in s.473(2) ITTOIA) is not attempted here. IPT Manual discusses the meaning of "annuity", a word used in many tax contexts:

> **1130. Fundamental concepts: what is an annuity?**
> There is no single definition in the taxes acts. There is an ancient definition in Stroud's Judicial Dictionary, quoting Coke on Littleton:
> An annuity is a yearly payment of a certaine summe of money granted to another in fee, for life, or yeares, charging the person of the grantor onely.
> From an early case called *Foley v Fletcher* (1858), 28 LJ Ex 100, the judgment of Watson B at 784-5 is often quoted:
> But an annuity means where an income is purchased with a sum of money, and the capital has gone and has ceased to exist, the principal having been converted into an annuity.
> From this and other cases, notably *Southern-Smith v Clancy*, 24 TC 1, the following factors emerge as needing to be present
> - the payments must be made under a legal obligation
> - those payments must be 'pure income profit'
> - they must be capable of being characterised as 'annual', so being capable of recurrence on a periodic basis by reference to an annual time frame
> - the purchase sum must pass absolutely to the provider
> - no debtor/creditor relationship is created in relation to that sum; it is replaced by the annuity
> - the annuitant's only right is to demand payments when due
> - the payments must not be instalments of pre-existing debt.

22.2.4 *Rights, parts and shares*

Section 464(3) ITTOIA provides:

> If there has been a surrender or assignment of only a part of or share in rights under the policy or contract, the references in this section and those sections to the rights are references to that part or share. [4]

ITTOIA EN comments:

4 This is repeated in s.468(6) ITTOIA. (If s.464(3) had ITTOIA-wide application this would have been unnecessary.)

417. *Subsection (3)* provides that references in sections 464 to 467 to a surrender or assignment of rights refer, where appropriate, to a surrender or assignment of a part of, or share of, the rights. A *part* of the rights means one or more discrete rights provided by the policy or contract. A *share* in the rights means part of the ownership, where there are multiple owners, of such a discrete right or rights or of all the rights in the policy or contract.

22.3 Outline of provisions

ITTOIA EN summarises the layout of the provisions:

409. The Chapter is laid out as follows-
• charge to tax under Chapter 9 (sections 461 to 463)
• person liable etc. (sections 464 to 472)
• policies and contracts to which Chapter 9 applies (sections 473 to 483)
• when chargeable events occur: general (sections 484 to 490)
• calculating gains: general (sections 491 to 497)
• part surrenders and assignments: periodic calculations and excess events (sections 498 to 509)
• transaction-related calculations and part surrender or assignment events (sections 510 to 514)
• personal portfolio bonds (sections 515 to 526)
• reductions from gains (sections 527 to 529)
• income tax treated as paid and reliefs (sections 530 to 538)
• deficiencies (sections 539 to 541)
• supplementary (sections 542 to 546)

22.3.1 *The charge*

The charge is in s.461(1) ITTOIA:

Income tax is charged on gains treated as arising[5] from policies and contracts to which this Chapter applies.

Section 463(1) ITTOIA provides:

5 The general usage of the CGT legislation is that gains "accrue"; in the chargeable events legislation, gains "arise". There is no difference in meaning.
Under the chargeable events legislation gains are sometimes said to "arise" and sometimes described as "treated as arising".

> Tax is charged under this Chapter on the amount of the gains arising in the tax year.

22.3.2 *Policies and contracts to which provisions apply*

This takes us to s.473(1) ITTOIA:

> This Chapter applies to—
> (a) policies of life insurance,
> (b) contracts for life annuities, and
> (c) capital redemption policies.

Sections 478–483 ITTOIA (not discussed here) specify various types of policies to which the provisions do not apply.

22.3.3 *When gains arise*

Section 462(1) ITTOIA provides:

> For the purposes of this Chapter, a gain from a policy or contract arises when a chargeable event occurs in relation to the policy or contract (see section 484).

22.3.4 *Chargeable event*

"Chargeable event" is a label which brings in a complex set of rules. Section 484(1) ITTOIA sets out the starting point:

> The following are chargeable events—
> (a) in the case of any kind of policy or contract—
> (i) the surrender of all rights under the policy or contract,
> (ii) the assignment of all those rights for money or money's worth,
> (iii) the falling due of a sum payable as a result of a right under a policy or contract to participate in profits, if there are no remaining rights under it,
> (iv) a chargeable event treated as occurring under section 509(1) (chargeable events in certain cases where periodic calculations show gains),

(v) a surrender or assignment treated as a chargeable event under section 514(1) (chargeable events where transaction-related calculations show gains), and

(vi) a chargeable event treated as occurring under section 525(2) (chargeable events where annual personal portfolio bond calculations show gains),

(b) in the case of a policy of life insurance, a death giving rise to benefits under it,

(c) in the case of a policy of life insurance or a capital redemption policy, its maturity,

(d) in the case of a contract for a life annuity which provides for the payment of a capital sum on death, the death, and

(e) in the case of a contract for a life annuity which provides for a capital sum to be taken as a complete alternative to the annuity payments (or any further annuity payments), taking the capital sum.

Thus there are ten types of chargeable event. They fall into two categories:

(1) **Calculation events.** Section 491(4) ITTOIA provides the terminology. There are three types of calculation event:

> In this Chapter—
> "calculation event" means an excess event, a part surrender or assignment event or a personal portfolio bond event,

Section 491(4) then defines these three types:

> [a] "excess event" means a chargeable event within section 509(1),
>
> [b] "part surrender or assignment event" means a chargeable event within section 514(1), and
>
> [c] "personal portfolio bond event" means a chargeable event within section 525(2).

The terminology of [a] and [b] is unhelpful, but it is hard to think of better labels for the tortuous rules in ss.509 and 514. Calculation events are therefore within s.484(1)(a)(iv), (v) or (vi).

(2) Other events: that is chargeable events other than calculation events. It is useful to have a label for these, but no short label fits the bill. I

call them "**the seven disposal-chargeable events**", because these events are disposals (in the natural sense or at least the CGT sense of the word).

Sections 484-489 ITTOIA contain exemptions. These are not discussed here, but s.487 is important because it contains an exemption for inter-spouse transfers (based on the CGT spouse exemption).

Logically there should be two stages, first to ascertain whether there is a chargeable event and secondly to compute the gain. But the two stages overlap because in three calculation event cases the question of whether there is a chargeable event depends on whether there is a gain.

It should be noted that an assignment for no consideration is not a chargeable event. This is the opposite of the CGT position.

22.3.5 *Computation of gains*

The computation of gains is complex and artificial and often bears no relation to the commercial gain. It is not the same as the computation of gains for CGT purposes, so one must take care not to confuse chargeable gains (the CGT term) and gains under the chargeable events legislation. It is confusing that the legislation calls them both "gains". The term "**chargeable event gains**" is useful when one needs to distinguish the two types of gains.

There are five different methods of computation for different types of chargeable events. The computation rules are not discussed here.

Once one has identified a chargeable event, and computed the chargeable event gain, the next stage is to ascertain the person liable for the charge.

22.4 Liability of individuals and individual "creators"

Section 465 ITTOIA provides:

> (1) An individual is liable for tax under this Chapter if the individual is UK resident in the tax year in which the gain arises and condition A, B or C is met.
> (2) Condition A is that the individual beneficially owns the rights under the policy or contract in question.
> (3) Condition B is that those rights are held on non-charitable trusts which the individual created.

(4) Condition C is that those rights are held as security for the individual's debt.

I call these "**individual bond conditions A to C**" to distinguish them from the myriad other conditions in ITTOIA.

Individual bond condition A – gain charged on individual if he is beneficial owner – is natural and sensible.

There are two strange features about individual bond condition B, where a policy or contract is held in a trust. Firstly, it does not refer to the "settlor", which is the normal tax terminology, but to trusts "created" by a person. In practice, the settlor will usually be the creator.[6]

Secondly, amazingly, the creator is charged on the gain accruing to his trust regardless of the identity of the beneficiaries. The individual has a right of recovery against the trustees, so ultimately it is the beneficiaries who bear the burden of the charge, but they do so at the creator's marginal rates. This is wholly contrary to principle, which elsewhere only charges the settlor in this way if he or those closely connected to him are beneficiaries. But following the increase in the trust tax rate to 40%, this rule can favour the taxpayer in relation to UK resident trusts.

Individual bond condition C – gain charged on individual if held as security for the individual's debt – is a rough and ready solution to the problem of imposing the tax charge where the economic ownership lies. CGT has the opposite rule: s.26 TCGA.

Sections 469–471 ITTOIA deal with joint ownership and s.672 ITTOIA deals with trusts with two or more settlors.

22.4.1 *UK resident foreign domiciled individual*

Section 465(5) ITTOIA provides:

> For the purposes of calculating the total income of an individual liable for tax under this Chapter, the amount charged is treated as income.

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6 The reason for the different term was, possibly, (1) to avoid the rule that a "settlor" must have provided an element of bounty or (2) a concern that a company may not be a "settlor"; see 58.33 (Trust made by company), or (most likely) (3) as a rough and ready way to deal with the two-settlor situation. That is, if A created a trust and B added property, A alone was the creator and was formerly subject to tax on the whole of the gain. But s.472 ITTOIA now provides a more sensible rule in this case.

The drafting technique is that the gain is added to the individual's "total income". The gain is taxed on an arising basis. The remittance basis does not apply even if the individual is a remittance basis taxpayer and the gain arises from an offshore policy. This is a surprising inconsistency with the general scheme of taxation for foreign domiciliaries. I wonder if this was due to a historical oversight. However that may be, the law set out in ITTOIA is clear.

It follows that a policy or contract which will give rise to a gain under the chargeable event provisions is not a suitable form of investment for:

(1) an individual who is a remittance basis taxpayer; or
(2) a trust whose creator is a remittance basis taxpayer,[7]

unless the individual expects to be non-resident in the year of the chargeable event. If the individual has no short or medium term intention of realising a gain (i.e. the policy is a long term investment) then the tax disadvantage can be set against the practical convenience of the policy.

The RDR Manual correctly provides:

> Chargeable event gains
> ...
> Gains arising on a chargeable event, for example, the surrender of all rights under a policy of life insurance are chargeable to tax on the arising basis regardless of whether the policyholder is domiciled in the UK or not. The remittance basis does not apply.
> Under a special rule (ITTOIA05/s507) policyholders are able to make partial surrenders or assignments of broadly up to 5% of accumulated premiums with any tax charge postponed until maturity or other later realisation. This is known as the '5% deferral rule' or the 'excess rule'. When the policy comes to an end any earlier withdrawals are taken into account in calculating the end gain.
> However when considering the position of a remittance basis user you will need to consider what income or gains they used to pay the premium due under the contract or policy. Where an individual purchases an overseas life insurance, or other income-generating, policy and subsequently part of that policy is surrendered for a cash payment and

7 But it may be suitable if held by a non-resident company held by the trust: see below.

that money is brought to the UK, such payments will be treated as taxable remittances to the extent that the purchase of the original premium was made with the individual's untaxed foreign income and gains that would have been taxed on the remittance basis if remitted to the UK..

So if the premium was paid using the individual's foreign income or foreign gains that were untaxed when they arose, because the individual was a remittance basis user in that year, then any of the 5% withdrawal will be a taxable remittance if the money is brought to, or received or used in, the UK.. The amount attributable to the '5% withdrawal' indirectly derives from the original premium paid, so Conditions A and B of s809L apply.

Withdrawals in excess of 5% or full surrenders

If the individual withdraws more than 5% of accumulated premiums then, the amount in excess of 5% or the actual gain if a full surrender, will be chargeable to income tax under the chargeable event legislation. It is charged on the arising basis whether it is remitted or not.

22.4.2 *Individual non-resident in year of chargeable event*

The charge only applies "if the individual is UK resident in the tax year in which the gain arises": s.465(1) ITTOIA.

Before ITTOIA, it was clear from ESC B53 that the split year concession did not apply. Now ESC B53 is obsolete, in relation to individuals, and this point is not expressly stated in ESC A11 which at face value applies a split year treatment in all cases including this one. However, it is likely that HMRC will not change their practice, and their decision to do that could not be challenged.

The temporary non-residence rule[8] does not apply. This is not an anomaly: it mitigates the unfairness of the lack of a remittance basis.

22.4.3 *Non-resident period relief*

There is a relief for the individual who is UK resident in the year that the gain arises (so he is within the charge) but who has formerly been non-resident. I refer to this as "**non-resident period relief**". The relief is set out in s.528 ITTOIA:

8 See 8.1 (Temporary non-residence).

> (1) The gain from a foreign policy of life insurance or foreign capital redemption policy[9] is reduced for the purposes of this Chapter if the policy holder was not UK resident throughout the policy period.
> (2) The amount of the reduction is the appropriate fraction of the gain.
> (3) The appropriate fraction is (A ÷ B) where—
> A is the number of days on which the policy holder was not UK resident in the policy period, and
> B is the number of days in that period.

The relief applies where individuals are charged on the gain as beneficial owners or security owners (bond conditions A or C). It does not help individuals who have had non-resident periods but who are charged as creators of a trust (bond condition B). Section 529(1) ITTOIA provides:

> Section 528 does not apply if, when the chargeable event occurs or at any time during the policy period, the policy is or was held—
> (a) by a non-UK resident trustee,
> (b) by non-UK resident trustees,[10] or
> (c) by a foreign institution.[11]

22.5 Liability of UK trust

If the creator of the trust is alive and UK resident, he will be taxed on the gain.[12] Section 467 ITTOIA provides for the situations where the creator is not taxable:

> **467 Person liable: UK resident trustees**
> (1) Trustees are liable for tax under this Chapter if immediately before the chargeable event in question occurs they are UK resident and condition A, B, C or D is met.
> (1A) If trustees are liable for tax under this Chapter, the gain is treated for income tax purposes as income of the trustees.
> (2) Condition A is that the rights under the policy or contract are held by the trustees on charitable trusts.

9 These terms are defined in s.476(3) ITTOIA.

10 It is clumsy and of course unnecessary to refer to trustee(s) both in the singular and the plural; but it does not matter.

11 For completeness, there is transitional relief for policies held on 19 March 1985: see para 106 Sch 2 ITTOIA.

12 See 22.4 (Liability of individuals and individual "creators").

(3) Condition B is that—
  (a) those rights are held by the trustees on non-charitable trusts, and
  (b) one or more of the absent settlor conditions is met.

(4) The absent settlor conditions are that the person who created the trusts—
  (a) is non-UK resident,
  (b) has died, or
  (c) in the case of a company or foreign institution (see section 468(5)), has been dissolved or wound up or has otherwise come to an end.

(5) Condition C is that—
  (a) the rights under the policy or contract are held by the trustees on non-charitable trusts,
  (b) condition B does not apply, and
  (c) neither section 465 nor section 466 applies.

(6) Condition D is that the rights under the policy or contract are held as security for a debt owed by the trustees.

The rate of tax (except for charities) was increased in 2004 to 40%: s.467(7) ITTOIA. An appointment to UK resident beneficiaries before the chargeable event may reduce the rate of tax and an appointment to non-resident beneficiaries may avoid tax altogether.

22.6 Non-resident trusts and companies

Non-resident trustees are outside the scope of the charge because s.467 (which imposes the charge on trustees) applies only to UK resident trustees.

A non-resident company is outside the scope of the charge under ITTOIA (which does not apply to companies). It is outside the scope of the charges in ICTA (which only apply to corporation tax).

In the absence of express provision, the chargeable event gain would not fall within the TAA provisions because the receipt by the person abroad (assuming he is non-resident) is capital and not income or (more fundamentally) the chargeable event gain is not income.[13] However, s.468 ITTOIA deals with this. It is helpful to consider trusts and companies separately.

13 See 17.13 (Capital receipts deemed to be income).

22.6.1 *Non-resident trusts*

Section 468 ITTOIA provides:

> (1) This section applies if a gain is treated as arising under this Chapter and ...
>
> (a) trustees who are non-UK resident would be liable for tax in respect of the gain as a result of section 467 if the trustees were UK resident immediately before the chargeable event in question occurs, ...
>
> (2) Chapter 2 of Part 13 of ITA 2007 (which prevents avoidance of tax where an individual who is ordinarily UK resident benefits from a transfer of assets) applies with the modifications specified in subsection (3) or (4).
>
> (3) In a case within subsection (1)(a), Chapter 2 of Part 13 of ITA 2007 applies as if—
>
> (a) the gain were income becoming payable to the trustees, and
>
> (b) that income arose to the trustees in the tax year in which the gain arises. ...

This incorporates ss.720[14] and 731 ITA.

22.6.2 *Non-resident company or institution*

Section 468 ITTOIA provides (so far as relevant):

> (1) This section applies if a gain is treated as arising under this Chapter and ...
>
> (b) immediately before that event occurs—
>
> (i) a foreign institution[15] beneficially owns *a share* in the rights,
>
> (ii) the rights are held for the purposes of a foreign institution, or

14 Section 720 ITA is not needed here because a transferor within s.720 would normally be taxed as the creator of the settlement, but the overlap does not matter. It is similar to the overlap of s.624 ITTOIA and s.720 ITA.

15 "Foreign" is defined in s.468(5) ITTOIA: "In this Chapter 'foreign institution' means a company or other institution resident or domiciled outside the UK." The word institution is not defined.

(iii) *a share* in them is held as security for a foreign institution's debt.

(Emphasis added)

It is curious that (i) and (iii) refer to *shares* in rights. Contrast ss.465(2) and 467(2) ITTOIA.[16] On a traditional approach to statutory construction the provision does not apply if the foreign institution beneficially owns the *entire* policy. The gap is not entirely filled by s.468(1)(b)(ii) (rights held for the purposes of a foreign institution). It is clear that there is a slip in the drafting, which on a modern approach to construction could and should be corrected. No doubt the drafting will be corrected some time.

Assuming s.468(1)(b) ITTOIA is satisfied, we read on:

> (2) Chapter 2 of Part 13 of ITA 2007 (which prevents avoidance of tax where an individual who is ordinarily UK resident benefits from a transfer of assets) applies with the modifications specified in subsection (3) or (4). ...
> (4) In a case within subsection (1)(b), Chapter 2 of Part 13 of ITA 2007 applies as if—
> (a) the gain were income becoming payable to the institution, and
> (b) that income arose to the institution in the tax year in which the gain arises.

Section 720 ITA is needed here, as the transferor would not otherwise be taxed on the gain. The extension of the scope of s.720 in 2005 caught those described in the 4th edition of this work as "bold enough to plan on the assumption that the current law will still apply when a policy is surrendered at some time in the future".

22.6.3 *Transferor's s.731 defence: gains arising before 5 December 2005*

Suppose:

(1) gains arose before 5 December 2005 to a foreign company or trust within s.731; the transferor was not subject to tax on those gains as

16 See 22.4 (Liability of individual and individual "creators") and 22.5 (Liability of UK trust).

they arose;[17] and

(2) the *transferor* receives a benefit.

A transferor is outside the scope of s.731: see 19.8 (Transferor's s.731 defence). Under the pre-5 December 2005 law, I suggested that the transferor's s.731 defence would not apply when s.720 did not apply. Now that s.720 does apply, the transferor's defence should apply even to pre-5 December 2005 gains. This could be something of a windfall for transferors; but since unrealised gains were brought within the s.720 charge from 5 December 2005, HMRC can hardly complain that realised gains now fall within the transferor's defence.

22.6.4 *Section 720 and s.731 remittance bases*

The s.720 remittance basis does not apply to a gain within s.720, because the gain does not meet the requirement that the income of the person abroad "would be relevant foreign income if it were the individual's".[18]

For the same reason, a benefit which relates to the gain does not qualify for the s.731 remittance basis.[19]

22.7 Section 624 and chargeable event gains

Section 624 ITTOIA never applies to a chargeable event gain. To see why, it is helpful to distinguish:

(1) UK resident settlor;
(2) non-UK resident settlor:
  (a) non-resident trustees;
  (b) UK resident trustees.

Where the settlor is UK resident he is taxed on the gain under basic principles as a creator. Section 624 does not apply because the gain is not income of the trustees.

Where the settlor is non-resident and the trustees are non-resident,

17 See the 4th edition of this book, para 20.5.
18 See 18.13 (Section 720 foreign domicile defence).
19 See 19.33 (Section 731 foreign domicile defence).

section 624 does not apply because the gain is not "income" and so it is not "income arising under a settlement".

Where the trustees are UK resident, but the settlor is not resident, the gain is deemed to be income of the trustees. In these circumstances the s.624 non-resident settlor defence will apply.[20]

22.8 Liability of personal representatives

Section 466 ITTOIA provides:

> (1) Personal representatives are liable for tax under this Chapter if
> [a] the rights under the policy or contract are held by them and
> [b] the condition in subsection (2) is met
> (and accordingly the gain is treated for income tax purposes as income of the personal representatives in that capacity).
> (2) The condition is that if an individual were liable for tax on a gain in respect of the policy or contract, section 530(1) (individual treated as having paid tax at the savings rate) would be disapplied as a result of—
> (a) section 531(1) (exceptions from section 530 for policies and contracts specified in section 531(3)), or
> (b) para 109(2) of Schedule 2 (contracts in accounting periods beginning before 1st January 1992).
> (3) [This usefully flags s.664 ITTOIA under which a gain not taxable on receipt treated as part of the aggregate income of the estate for the purposes of the taxation of a beneficiary's estate.]

The condition in subsection (2)(b) is a transitional rule now of limited scope.

In order to understand the condition in subsection (2)(a) one needs to follow a trail of statutory provisions. Firstly, ss.530 and 531 ITTOIA:

> **530 Income tax treated as paid etc.**
> (1) An individual or trustees who are liable for tax on an amount under this Chapter are treated as having paid income tax at the basic rate on that amount.
> ...

20 That is, the gain is such that if the settlor were actually entitled thereto, he would not be chargeable to income tax by reason of being non-resident: see 16.9 (Section 624 non-residence defence to s.648).

I refer to this as a “**s.530 tax credit**”.

> **531 Exceptions to section 530**
> (1) Section 530 does not apply to gains from the kinds of policies and contracts specified in subsection (3), except for the purposes of calculating relief under section 535 (top slicing relief).
> (2) Subsection (1) is subject to—
> section 532 (relief for policies and contracts with European Economic Area insurers), and
> section 534 (regulations providing for relief in other cases where foreign tax chargeable).
> (3) The policies and contracts are—
> (a) a policy of life insurance issued or a contract for a life annuity made by a friendly society in the course of tax exempt life or endowment business[21],
> (b) a foreign policy of life insurance that does not meet conditions A and B,
> (c) a contract for a life annuity (other than one within para (a)) which has at any time not formed part of any insurance company’s or friendly society’s basic life assurance and general annuity business the income and gains of which are subject to corporation tax, and
> (d) a foreign capital redemption policy.

If we focus on foreign life policies, the relevant provision is (3)(b). The question is whether the foreign policy does not meet conditions A and B (which I will call “**foreign policy conditions A and B**”. Section 531(5) provides:

> Condition A is that the policy falls within para (a) of the definition of “foreign policy of life insurance” in section 476(3) (policy issued by a non-UK resident company).

So we turn to s.476(3) ITTOIA:

21 Terms defined in subsection (4); the definitions need not be considered here.

In this Chapter—
"foreign policy of life insurance" means—
(a) a policy of life insurance issued by a non-UK resident company, and
(b) a policy of life insurance which forms part of the overseas life assurance business of an insurance company or friendly society as a result of section 431D(1) of ICTA (business with a non-UK resident policy holder).

A foreign policy will typically fall within that definition, so it will meet the condition in s.476(3)(a). We then turn to s.431D(1) ICTA:

431D Meaning of "overseas life assurance business"
(1) In this Chapter "overseas life assurance business" means so much of a company's relevant life assurance business as is with a policy holder or annuitant not residing in the UK (but not including the reinsurance of such business).

I think we conclude that most foreign policies will satisfy foreign policy condition A. That takes us to foreign policy condition B:

(6) Condition B is that the conditions in para 24(3) of Schedule 15 to ICTA (conditions that are required to be met for certain policies issued by non-UK resident companies to be qualifying policies) are met throughout the period between—
(a) the date on which the policy was issued, and
(b) the date on which the gain arises.

It is easy to become tangled in the double double negatives, but I think the chain of reasoning goes as follows:

(1) Foreign policies will not (usually) satisfy condition B.
(2) So they fall within s.534(3)(b) ("a foreign policy of life insurance that does not meet conditions A and B").
(3) So they do not qualify for a s.530 tax credit.
(4) So they do meet the condition in s. 466(2).
(5) So that PRs are liable for the chargeable event gain.

This could be avoided by an assent to a beneficiary.

Section 466 ITTOIA is not expressed to be limited to UK resident PRs. However s.368 ITTOIA provides:

> (1) Income arising to a UK resident is chargeable to tax under this Part whether or not it is from a source in the UK.
> (2) Income arising to a non-UK resident is chargeable to tax under this Part only if it is from a source in the UK.
> (3) References in this section to income which is from a source in the UK include, in the case of any income which does not have a source, references to income which has a comparable connection to the UK.
> (4) This section is subject to any express or implied provision to the contrary in this Part (or elsewhere in the Income Tax Acts).

Thus non-resident PRs are not chargeable. ITTOIA EN confirms that this is intended:

> 421. Chapter 1 of Part 4 of this Act provides a general territorial limitation on the scope of the Part. As regards income arising outside the UK, it limits the charge to such income arising to a UK resident. See section 368 (territorial scope of Part 4 charges) and the related commentary on that Chapter. [Section 465 ITTOIA] overlaps and supplements that Chapter to ensure that a non-UK resident individual is not liable to tax under this Chapter on any gains, whether arising in the UK or elsewhere.

22.9 Planning for immigrant to UK

22.9.1 *Immigrant policyholder who has become resident in the UK*

The advisers of a foreign domiciled person who has recently come to the UK should check whether he or any trust he has created has a policy or contract. If so, the position needs to be reviewed.

An assignment of the policy or contract from an individual to a trust (resident or not) does not help, since the individual remains liable as creator.

One simple form of planning is to arrange there is no chargeable event in a year when the individual is UK resident. The partial surrender of up to 5% of the premium paid for the policy or contract per year is not a chargeable event. The surrender, assignment for money or money's worth and maturity of the policy or contract is normally a chargeable event but this can be anticipated and perhaps postponed to a year when the individual is non-resident. A death giving rise to benefits under the policy is also a chargeable event unless the policy is a qualifying policy. In such a case one would be at risk that the individual may die while UK resident, giving rise to the tax charge on his estate.

Another course is for the individual to surrender his policy shortly after becoming UK resident; most of the gain will qualify for non-resident period relief.[22]

If a chargeable event is anticipated, the policy or contract could be assigned to a non-resident company, perhaps held by a trust. This postpones the charge to the time that an ordinarily resident individual receives benefits.[23] An assignment for no consideration is not a chargeable event.

22.9.2 *Planning before becoming UK resident*

There are further possibilities if the individual acts before the tax year in which he becomes UK resident. One possibility is to surrender the policies.

22.10 Personal portfolio bonds

Urgent action needs to be taken if the individual (or trust created by him) holds a "personal portfolio bond" as defined in s.516 ITTOIA. This topic cannot be pursued here.

22.11 CGT exemption for policies

Sections 204 and 210 TCGA provide exemptions for policies and contracts. In outline, policies are exempt unless assigned for consideration (known as secondhand policies).

22.12 IHT on policy held by foreign domiciliary

The IHT Manual provides:

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22 See 22.4.3 (Non-resident period relief).

23 See 22.6.2 (Non-resident company or institution).

IHTM30039 - Policies effected by a person who dies domiciled outside the UK [October 2007]

Under the proviso to the [Revenue Act][24] 1884 s.11 as amended by the [Revenue Act] 1889 s.19 a grant of representation (IHTM05001) in the UK is not necessary in order to recover money payable under a policy of life assurance effected with any insurance company by a person who dies domiciled[25] outside the UK. For the purposes of this section, any policy under which a sum of money becomes payable on a death may be treated as a policy of life assurance, and any association of persons which issued policies in the ordinary course of its business, whether incorporated or not, may be treated as an insurance company.

These provisions do **not** confer any exemption from IHT. Where policy moneys are situate in the UK, tax is nonetheless payable though the moneys may be receivable without the production of a UK grant of representation.

The insurance company can however be liable for the tax where

[1] it retains policy moneys for the benefit of the beneficiary for investment purposes, outside the terms of the life assurance contract, in which case IHTA s.200(1)(c) may apply to the company as a vestee, or

[2] it received prior notice that the policy in question is subject to a statutory charge for tax under s.237 IHTA.[26]

Where there is other estate in the UK in respect of which a UK grant is necessary, but the UK representatives are only administrators acting under a power of attorney and in point of fact have not intermeddled with the policy moneys and, without knowledge of the claim for tax in respect of such moneys, have parted with the assets collected by them to their principal (the foreign executor), the claim in respect of the policy moneys should not be pursued against the UK administrators.

Similar conditions apply in Scotland to a Factor or Attorney authorised by executors abroad to give up an Inventory (in such cases it is the executors who are confirmed, not the Factor or Attorney).

Refer to TG [Technical Group] for consideration

- all enquiries on this topic
- any case where it is apparent that policy moneys have been paid out without a grant being produced.

(This text has been withheld because of exemptions in the Freedom of Information Act 2000)

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24 The Manual wrongly refers to the Customs & Inland Revenue Acts.

25 The deemed domicile rule does not apply for this purpose.

26 In practice it is unlikely that either [1] or [2] will be the case.

The withheld text may well state that IHT in many cases is uncollectable and set out the circumstances in which no attempt should be made to collect it. In practice a well advised foreign domiciliary (not deemed domiciled) will not acquire or retain a UK situate policy. However a person who is deemed UK domiciled may find this useful, as the executors can fund IHT more easily if they can first recover the money due under the policy and then pay the IHT and obtain a grant.

CHAPTER TWENTY THREE

OFFSHORE FUNDS UNTIL 1 DECEMBER 2009

23.1 Offshore funds – Introduction and terminology

This subject needs a long book to itself. It would be an unrewarding work, however, because the rules are not well observed in practice. The reader who studies this chapter will see why.

In outline, the provisions apply to an offshore income gain arising on a disposal of a material interest in a non-qualifying offshore fund. These terms are elaborately defined.

The legislation distinguishes:

(1) offshore income gains ("**OIGs**"), gains within the scope of the offshore funds rules; and
(2) chargeable gains (gains within the scope of CGT). I refer to this for clarity as "**CGT chargeable gains**" though strictly the term "chargeable gains" is only applicable to CGT.

In this chapter I use the following terminology:

CIS:	Collective Investment Scheme.
CIS Order:	Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001.
OEIC:	Open-ended investment company.

I also distinguish between (1) **CGT s.87 gains** and **CGT s.2(2) amounts** and (2) **OIG s.87 gains** and **OIG amounts,** but I leave the explanation of those terms to the s.87 discussion below.

For OIGs accruing to charity, see Taxation of Charities, 7th edition, Kessler & Brown, para 2.12.

23.2 Meaning of "offshore fund"

The definition is provided by s.756A(1) ICTA. An offshore fund is:

> a collective investment scheme constituted by—
> (a) a company that is resident outside the UK, or
> (b) a unit trust scheme the trustees of which are not resident in the UK,[1] or
> (c) arrangements not falling within para (a) or (b) taking effect by virtue of the law of a territory outside the UK and which under that law create rights in the nature of co-ownership (without restricting that expression to its meaning in the law of any part of the UK).

The key term here is "collective investment scheme" ("CIS"). Section 756B and 756C ICTA (not discussed here) deal with umbrella funds and funds with more than one class of interest.

The Inspectors Manual (now withdrawn) commented on s.756(1)(c) ICTA:

> An offshore fund can take the form of a non-resident company or unit trust, or any other arrangements which take effect under foreign law and create rights in the nature of co-ownership. This will generally include a foreign partnership, but partnerships are unlikely to be affected by the provisions as an interest in a partnership is generally regarded, for UK CGT purposes, as constituting no more than a share in each of the underlying assets of the partnership (see CG27161 onwards).

This point does not seem to be made in the SII Manual.

23.3 "Collective investment scheme"

The definition is one of the most intricate in the tax code, and that is really saying something.[2]

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1 See 27.2.4 (Residence of trustees of unit trust).

2 See "Offshore funds: the pitfalls of legislation by reference" [2007] BTR 522 (Fraser & Phillips).

23.3.1 *General definition*

Section 756A(3) ICTA provides:

> In this section "collective investment scheme" means
> [a] any arrangements which are a collective investment scheme for the purposes of Part 17 of the Financial Services and Markets Act 2000 (see s.235 of that Act and orders made under subsection (5) of that section) or
> [b] would be [a CIS] if the words ", within a period appearing to him to be reasonable," were omitted from 236(3)(a) of that Act."

So we turn to s.235 FISMA 2000:

> (1) In this Part "collective investment scheme" means any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.
> (2) The arrangements must be such that the persons who are to participate ("participants") do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions.
> (3) The arrangements must also have either or both of the following characteristics—
> (a) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled;
> (b) the property is managed as a whole by or on behalf of the operator of the scheme.

This is very wide, but there are very wide exceptions.

23.3.2 *Exceptions to general definition*

Section 235(5) FISMA 2000 provides:

> The Treasury may by order provide that arrangements do not amount to a collective investment scheme—
> (a) in specified circumstances; or

(b) if the arrangements fall within a specified category of arrangement.

The relevant regulations are the CIS Order 2001. This sets out 21 categories of exceptions. Fortunately most of them are not relevant here.

23.3.3 *Exception for non-OEICs*

Para 21 of the Schedule to the CIS Order 2001 provides:

> [1] No body incorporated under the law of, or any part of, the UK relating to building societies or industrial and provident societies or registered under any such law relating to friendly societies, and
> [2] no other body corporate other than an open-ended investment company,
> amounts to a collective investment scheme.

The exclusion in para 21[2] is very important. I refer to companies which are not OEICs as "**non-OEICs**".

23.3.4 *Definition of "OEIC"*

The definition of OEIC is crucial since non-OEICs are excluded under para 21[2] of the Schedule to the CIS Order 2001. Unfortunately the CIS Order 2001 fails to supply a definition! However HMRC assume (as the context suggests) that the definition is that in s.236 FISMA:

> (1) In this Part "an open-ended investment company" means a collective investment scheme which satisfies both the property condition and the investment condition.
> (2) The property condition is that the property belongs beneficially to, and is managed by or on behalf of, a body corporate ("BC") having as its purpose the investment of its funds with the aim of—
> (a) spreading investment risk; and
> (b) giving its members the benefit of the results of the management of those funds by or on behalf of that body.

A CIS will easily satisfy the property condition, so the investment condition is important:

(3) The investment condition is that, in relation to BC, a reasonable investor would, if he were to participate in the scheme—

(a) expect that he would be able to realize, ~~within a period appearing to him to be reasonable~~, his investment in the scheme (represented, at any given time, by the value of shares in, or securities of, BC held by him as a participant in the scheme); and

(b) be satisfied that his investment would be realized on a basis calculated wholly or mainly by reference to the value of property in respect of which the scheme makes arrangements.[3]

The words printed in strikeout are to be disregarded for offshore funds tax under s.756A(3)[b] ICTA, so there are two definitions of OEIC:

(1) the original s.236 definition ("**a FISMA OEIC**");
(2) the amended definition ("**an Offshore Fund OEIC**"). This is slightly wider.

Hence there are two distinct definitions of collective investment scheme:

(1) the FISMA definition ("**FISMA CIS**");
(2) the Offshore Fund definition ("**0ffshore Fund CIS**"); this is slightly narrower.

23.3.5 *FISMA OEIC*

The key condition is the investment condition of an OEIC: would the reasonable investor expect to be able to realise his investment *within a reasonable period*? To answer that question one must first decide what is a reasonable period. HMRC explain their views:[4]

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3 For completeness, s.236 continues:

"(4) In determining whether the investment condition is satisfied, no account is to be taken of any actual or potential redemption or repurchase of shares or securities under—

(a) Chapter VII of Part V of the Companies Act 1985; [and other specified corresponding provisions]

(5) The Treasury may by order amend the definition of 'an open-ended investment company' for the purposes of this Part."

4 Published on HMRC website on 17 May 2007; see *http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_027504*.

Part 3: Meaning of "reasonable period"

The offshore funds regime already had a reference to a "reasonable period" in the definition of "material interest" (at s.759 ICTA). This limited the application of the offshore income gain rule to the disposal of an interest where the investor had a reasonable expectation of realising the interest within a seven year period. HMRC has consistently taken the view that the "reasonable period" that limited the meaning of collective investment scheme in s.756A ICTA was the same as the seven year period in s.759 ICTA that limited the meaning of material interest.

The Financial Services Authority (FSA) issued guidance on the interpretation of the meaning of "open-ended investment company" ... and the guidance is now at PERG 9.11.1:[5] ***The meaning of open-ended investment company: Frequently Asked Questions: Nos 4 and 8.***[6]

The response to FAQ 8 is as follows.

> *"In the FSA's view a period of six months would generally be too long to be a reasonable period for a liquid securities fund. A shorter period affording more scope for an investor to take advantage of any profits caused by fluctuations in the market would be more likely to be a reasonable period for the purpose of the realisation of the investment (in the context of the 'expectation' test, see PERG 9.8 and, in particular, PERG 9.8.9 G which sets out the kind of factors that may need to be considered in applying the test)."*

An important point to make is that this does not (as has been suggested) introduce an upper limit of six months on the length of period which is reasonable to decide if any investment company is open-ended. The reply to FAQ8 is in the context of liquid securities funds that are offering redemption or repurchase of securities, and should not be extrapolated beyond that.

The position of a fixed-term closed-ended investment company is considered in the reply to FAQ4, and quotes the statement made by the Economic Secretary to the Treasury when FSMA was introduced:

> *"the aim and effect [of the definition] is to cover companies that look, to a reasonable investor, like open-ended investment companies…A reasonable investor's overall expectations of a potential investment in a company when its status with respect to the definition is being judged will determine whether it meets this definition. The matter is therefore definitional rather than one of proximity to liquidation."*

It is also useful to look at the specific reference PERG 9.8.9 G: to understand the limits to the guidance in FAQ8:

> *"As indicated in PERG 9.3.5 G (The definition), the potential for variation in the form and operation of a body corporate is considerable. So, it is only possible in general guidance to give examples of the factors that the FSA considers may affect any particular judgment. These should be read bearing in mind any specific points considered elsewhere in the guidance. Such factors include:*

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5 *http://fsahandbook.info/FSA/html/handbook/PERG/9*.

6 [Author's Note: PERG 9 is accessible on *http://fsahandbook.info/FSA/html/handbook/PERG*.]

(1) the terms of the body corporate's constitution;
(2) the applicable law;
(3) any public representations that have been made by or on behalf of the body corporate;
(4) the actual behaviour of the body corporate or of a person acting on its behalf in relation to investors seeking to realise their investment in it;
(5) whether investors in the body corporate are in a position to take advantage of fluctuations in property value in the particular market in which the body corporate invests;
(6) the existence of a guarantee, which may mean that a longer period may appear reasonable than would be the case without the guarantee;
(7) where the underlying property in which the body corporate invests is relatively illiquid; in this case, the period within which realisation of an investment may be regarded as reasonable may be longer than it would be for property which has greater liquidity;
(8) the levels of disclosure of the terms on which investment is made;
(9) the nature of the investment objectives or policy of the body corporate; and
(10) the appropriateness of the name of the body corporate."

The FSA guidance, therefore, is a general view that is applicable in the context of their regulatory rules and cannot be relied upon as indicative of an absolute view in the context of other rules that do contain explicit meanings of certain terms.

HMRC's view has been since 29 November 1994 that a "reasonable period" in the context of whether a company is a collective investment fund for the purposes of the offshore funds regime is seven years, derived by reading s.756A together with 759 ICTA.

The HMRC argument is, to say the least, unconvincing and HMRC were right to change the law in 2007.

23.3.6 *Offshore fund OEIC*

HMRC's comments are lengthy but need to be set out in full:

Definition of Offshore Fund: BN29

It is intended to put beyond doubt that an open-ended company is not prevented from being an offshore fund in which an investor may have a material interest for the purposes of sections 756A and 759 ICTA purely by virtue of failing the "reasonable period" test in s.236 Financial Services and Markets Act 2000 ("FSMA"). ...

Clause 56 achieves its aim by removing the reference to "reasonable period" in s.236 FSMA when that section is used in the context of the offshore funds regime.

> **Clause 56 does not seek to return the compass of the offshore funds regime to the pre Finance Act 1995 position.**
> Some advisers and fund managers have raised concerns that this may bring some **offshore companies** within the rules that were previously not considered to be "open-ended" for the purposes of either FSA regulation or the offshore fund regime.

After a passage of irrelevance and waffle,[7] the statement continues:

> From a tax perspective the **presumption ought therefore to be that a company with fixed capital is outside the offshore fund definition unless there are special conditions to suggest the contrary.** ...

The statement then turns to some practical examples (branded FAQs):

> ***1. Are investors in a "limited life" closed ended investment company who buy shares less than seven years before the end of the company's life treated differently from those who bought earlier?***
> Here the concern is that investors in a company with, say, a ten-year life who buy shares three years or more after the company is set up would be affected by the offshore income gain rules whereas an investor who bought at the outset (when the company did have more than seven years left to run) would not be.
> The s.236 FSMA 2000 definition, as modified by clause 56 of the Finance Bill, applies to the company as a whole and not to the status in the context of an individual investor in that company. If, applying that modified definition, the company is not an open-ended investment company when its shares are first offered, it does not become one seven years before the winding up date.

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7 "The offshore funds regime applies only to an entity defined as a collective investment scheme within s.235 of FSMA. In considering whether that is the case, the Economic Secretary's statement that the definition of a collective investment scheme in FSMA is intended to cover companies that look to a reasonable investor like open-ended investment companies can helpfully be considered."

I don't think so.

"This view is also supported by the statement made by the Minister during the debate on the relaxation of the definition of an offshore fund that was introduced in 1995 by s.134 FA 1995 (when there was no reference to 'reasonable period' in the Financial Services Act definition of open-ended companies):

'If, however, evidence emerged that tax planners were attempting to abuse the relaxation by creating vehicles that did not fall within the Financial Services Act 1986 definition of collective investment schemes but that could in some way be used to roll up income, the Government would not hesitate to withdraw it.'"

I cannot follow this, because the company would be an offshore fund OEIC when its shares were first offered.

> ***2. What is the position of an investment company which has some classes of shares that are redeemable and others that are not?***
> As with FAQ 1, we need to look at the company as a whole. The company cannot be "open-ended" for investors in one class of shares but not in respect of investors in another class of shares.
> The overall balance of the company must be looked at to determine whether or not the company is an open-ended investment company. In looking at the company as a whole, HMRC may however disregard the existence of a small tranche of non-redeemable shares if its whole or main purpose is to create a class of investors with no expectation of realisation within a reasonable period.
> ***3. Is an investment company that offers early redemption by reference to an index open-ended?***
> Here we are looking at the type of company that offers to redeem shares issued for £100 in say three years time at £100 x F1002010 /F1002007 where F1002007 is the FTSE 100 index at the 2007 date of issue and F1002010 is the FTSE 100 index at the 2010 redemption date.
> HMRC would not regard such a company as meeting the "satisfaction" test in the s.236 FSMA definition of "open-ended investment company". That test requires the reasonable investor to expect to receive an amount calculated wholly or mainly by reference to the net asset value (NAV) of the fund's property. Where the return at the three-year redemption point is by reference to the movement in an index, then it is not calculated by reference to NAV. The company will not therefore be open-ended and consequently is not caught by the offshore funds regime.

This seems correct.

> ***4. Is it different if redemption is index-linked with no access to out-performance?***
> Looking at the same type of company as in FAQ 3, the concern here is whether the view would be different if the company invested only in instruments designed to produce exactly the promised return.
> This would depend on what happened if, at the three-year point, the fund's investments had performed better or worse than the index.
> The company may for example restrict redemption proceeds if the provider of one of the instruments has defaulted but limit the pay-out to £100 x F1002010 /F1002007 even if one of the instruments does in fact out-perform the index. Where there has been default or where the instruments deliver exactly the promised return, the redemption proceeds will be equal to NAV. But if the redeeming investor cannot benefit from any out-performance of the index, then

the investor cannot expect the redemption to be calculated by reference to NAV, even though in most cases it is expected to be the same.
HMRC would not regard a company which offered early redemption by reference to an index, which did not allow the investor access to out-performance, as being an open-ended investment company.
It would not, therefore, be within the offshore funds regime.

This seems correct.

5. What about a company that offers a defined return with a lower limit on redemption?
Here we are looking at a company which offers shares that will be redeemed in say five years time by reference to changes in the price of a notional portfolio of, for example, precious metals but with guaranteed minimum redemption proceeds equal to the subscription price.
As with FAQs 3 and 4, even though in practice, the investor is likely to obtain their share of the NAV at redemption, this may not be the case if prices of precious metals fall, or if the instruments acquired by the company to generate the return out-perform the value of the notional portfolio.
HMRC would not regard such a company as being an open-ended investment company as defined in s.236 FSMA, as modified by clause 56 for the purposes of s.756A ICTA. It would not therefore be within the offshore funds regime.

This seems correct.

6. Is a company that has a conditional redemption clause that could be triggered within seven years of establishment an open-ended investment company?
Some companies include in their prospectus an intention for the directors to seek to redeem a class of shares or to wind up the company in say three to seven years time if the fund's investments meet certain performance criteria.
HMRC would not regard such an intention to redeem or wind up as amounting to a reasonable expectation by an investor that they can redeem their investment. This is because it is conditional on the performance of the investment assets, the actions of the directors and obtaining the assent of the majority of shareholders. The company would not therefore be an open-ended investment company as defined in s.236 FSMA, as modified by clause 56 for the purposes of s.756A ICTA because the "satisfaction test" is not met. It would not therefore be within the offshore funds regime.

This seems correct.

7. Is a company that offers a window for redemption open-ended and therefore potentially within the offshore funds regime?

If the company includes in its prospectus the intention that shares will be redeemed within a set period, dependent only on action taken by the directors, then following the introduction of clause 56 the length of the redemption window is unlikely to affect whether or not the company is open-ended but may affect the application of the offshore fund regime to investors if the company is, in fact, open-ended and therefore within the offshore funds regime.

If the fund is open-ended the length of the window for redemption will determine if shares in the company amount to a "material interest" for the purposes of s.759 ICTA.

If the redemption period is say three to seven years from the date the company issues the shares, then the shares are likely to be a material interest in the company, as the investor can reasonably expect to redeem their investment within a seven year period.

If the redemption period is four to eight years from issue, then the investor does not have an expectation of redemption within seven years. In that case, the shares would not be a material interest for s.759 ICTA purposes.

But the fund would be an offshore fund.

8. What is the position for a "limited life" investment company which plans to deliver capital growth but has less than a seven-year life?

This type of company would typically be set up to offer a return based on the performance of various indices, similar to FAQs 3 and 5. On winding up, after say five years, investors would receive their share of NAV after costs of liquidation. This type of fund may be an open-ended investment company as defined in s.236 FSMA, as modified by clause 56 for the purposes of s.756A ICTA.

If it is an open-ended company and therefore within the offshore funds regime the shares would also constitute a material interest in the company, as an investor could reasonably expect to realise their investment at or close to NAV within seven years.

If the fund is designed to provide capital growth and its investments are similarly structured, it is likely that the company could qualify as a "distributing fund" as an offshore fund that receives no income can nonetheless meet the distribution test. The offshore income gain rules would not therefore apply on disposal of shares during the life of the company or on winding up and any gain or loss on the shares would be taxable under the chargeable gains rules.

There are companies that are designed to produce a total return, for example, an equity-based fund where redemption proceeds will reflect dividends as well as growth in share prices over the period. HMRC's view is that it is the kind of fund that aims to roll-up of income, free of UK income tax and is the type of collective investment scheme at which the offshore funds legislation is targeted. Unless the company pursued a distribution policy that satisfied the tests in Schedule 27 ICTA, investors would be subject to the offshore income gain rules when they dispose of their shares in the company.

The statement continues with comments on transitional rules which cannot be discussed here.

23.4 Meaning of "non-qualifying" fund

Section 760(1) ICTA provides:

> For the purposes of this Chapter, an offshore fund is a non-qualifying fund except during an account period of the fund in respect of which the fund is certified by the Board as a distributing fund.

It is not enough to met the requirements for certification, the fund has to obtain the certificate for each accounting period.[8] Section 760 then sets out the requirements:

> (2) An offshore fund shall not be certified as a distributing fund in respect of any account period unless, with respect to that period, the fund pursues a full distribution policy, within the meaning of Part I of Schedule 27.
> (3) Subject to Part II of that Schedule, an offshore fund shall not be certified as a distributing fund in respect of any account period if, at any time in that period—
> (a) more than 5 per cent by value of the assets of the fund consists of interests in other offshore funds.[9]

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8 For the requirements see HMRC Offshore Funds Guide.

9 For this purpose "offshore fund" has a narrower definition: see s.756A(4) ICTA:

> "But the reference to offshore funds in s.760(3)(a) does not include any arrangements which are not a collective investment scheme for the purposes of that Part of that Act."

HMRC explain the reason:

> "Concern has also been expressed that one unintended effect of clause 56 of Finance Bill 2007 could be to cause funds that are currently certified as distributing funds to lose that status, as a result of inadvertently holding interests in companies that were not considered to be offshore funds prior to the change made by the clause. This might arise if more than five per cent of the certified fund's assets consist of interests in such companies, so that the test at s.760(3)(a) ICTA is failed. To resolve this issue, the Government has tabled a further amendment proposing that the clause 56 change shall not apply for the purposes of defining "offshore funds" as the term appears in s.760(3)(a) ICTA; i.e. that the FSMA definition of a collective investment scheme (unmodified by clause 56) should continue to be applied for the purposes of

Thus there are two sets of requirements:

(1) a full distribution policy (elaborately defined), in short, distributing 85% of profits; and
(2) (subject to exceptions) not to hold more than 5% of other offshore funds.

HMRC publish a list of certified funds.[10] Non-qualifying funds tend to out-perform distributing funds. The best fund managers no doubt see no advantage in complying with the rules for distributing fund status. So investors may have the unhappy choice between investment return and better tax treatment. Non-qualifying funds are sometimes known as "roll u p funds".

23.5 Meaning of "material interest"

"Material interest" is a (not particularly apt) label for a disparate collection of rules.

23.5.1 *The seven-year test*

Section 759(2) ICTA provides:

> Subject to the following provisions of this section, a person's interest in an offshore fund is a material interest if, at the time when he acquired the interest, it could reasonably be expected that, at some time during the period of seven years beginning at the time of his acquisition, he would be able to realise the value of the interest[11] (whether by transfer,

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the 5 per cent test in s.760(3)(a) ICTA."

10 See *www.hmrc.gov.uk/offshorefunds/dist_fundlist.htm*.

11 "Able to realise the value of the interest" is defined in s.759(3)(4) ICTA:

"(3) For the purposes of subsection (2) above, a person is at any time able to realise the value of an interest if at that time he can realise an amount which is reasonably approximate to that portion which the interest represents (directly or indirectly) of the market value at that time of the assets of the fund.

(4) For the purposes of subsections (2) and (3) above—

(a) a person is able to realise a particular amount if he is able to obtain that amount either in money or in the form of assets to the value of that amount; and surrender or in any other manner).

I refer to this as the seven-year test.

23.5.2 *Policy of insurance*

Section 759(5) ICTA provides:

> An interest in an offshore fund is not a material interest if ...
> (b) it is a right arising under a policy of insurance.

This has been otiose since 1995, since para 17 of the Schedule to the FISMA (CIS) Order 2001 provides:

> A contract of insurance does not amount to a collective investment scheme.

Insurance policies are excluded because they are covered by the chargeable events provisions.

23.5.3 *Offshore companies*

An offshore company is not usually a CIS (and so not an offshore fund) for one of two reasons:

(1) A wholly owned non-resident company is not within the general definition of CIS.
(2) Companies other than OEICs which might otherwise fall within the general definition are excluded under the CIS Order 2001.[12]

There are two further exceptions, though these are not important after 1995. Section 759(8) ICTA provides:

(b) if at any time an interest in an offshore fund has a market value which is substantially greater than the portion which the interest represents, as mentioned in subsection (3) above, of the market value at that time of the assets concerned, the ability to realise such a market value of the interest shall not be regarded as an ability to realise such an amount as is referred to in that subsection."

12 See 23.3.3 (Exception for non-OEICs)

> An interest in a company that is not resident in the UK is not a material interest in an offshore fund at any time when the following conditions are satisfied, namely—
> (a) that the holder of the interest has the right to have the company wound up; and
> (b) that, in the event of a winding up, the holder is, by virtue of the interest and any other interest which he then holds in the same capacity, entitled to more than 50 per cent of the assets remaining after the discharge of all liabilities having priority over the interest or interests concerned.

A shareholding which carries the right to wind up the company will normally qualify for this exemption. A shareholding which does not carry the right to wind up the company will not normally meet the seven-year test, so one way or another, offshore companies are not normally caught by the offshore funds legislation.

For completeness, s.759(6) ICTA contains an elaborate and narrow exemption where (in short) an offshore company is held by a trading company for the maintenance and development of its trade. This is not likely ever to be needed.

23.6 "Disposal to which this chapter applies"

The provisions frequently refer to a "disposal to which this chapter applies". This expression is defined in s.757(1) ICTA:

> This Chapter applies to a disposal by any person of an asset if—
> (a) at the time of the disposal, the asset constitutes a material interest in an offshore fund which is or has at any material time been a non-qualifying offshore fund; or
> (b) at the time of the disposal, the asset constitutes an interest in a company resident in the UK or in a unit trust scheme, the trustees of which are at that time resident in the UK and at a material time after 31 December 1984 the interest was a material interest in a non-qualifying offshore fund.

Paras (a) and (b) are both needed, for para (a) deals with offshore funds and para (b) catches funds which were previously non-resident.

23.7 Meaning of "disposal"

In outline, the position is governed by s.757(2) ICTA:

> Subject to the following provisions of this section and s.758, there is a disposal of an asset for the purposes of this Chapter if there would be such a disposal for the purposes of the [TCGA].

Special rules relating to reorganisations are not discussed here.

23.8 Death of individual

Section 757(3) (4) ICTA provides:

> (3) Notwithstanding anything in para (b) of subsection (1) of s.62 of the 1992 Act (general provisions applicable on death: no deemed disposal by the deceased) where a person dies and the assets of which he was competent to dispose include an asset which is or has at any time been a material interest in a non-qualifying offshore fund, then, for the purposes of this Chapter, other than s.758—
> (a) immediately before the acquisition referred to in para (a) of that subsection, that interest shall be deemed to be disposed of by the deceased for such a consideration as is mentioned in that subsection; but
> (b) nothing in this subsection affects the determination, in accordance with subsection (1) above, of the question whether that deemed disposal is one to which this Chapter applies.
> (4) Subject to subsection (3) above, s.62 of the 1992 Act applies for the purposes of this Chapter as it applies for the purposes of that Act, and the reference in that subsection to the assets of which a deceased person was competent to dispose shall be construed in accordance with subsection (10) of that section.

23.9 Computation of OIGs

OIGs are computed in accordance with Schedule 28 ICTA. Following the abolition of CGT indexation and taper reliefs the amount of an OIG accruing on a disposal is usually the same as the amount of a CGT chargeable gain would have been had the asset not been an offshore fund. There is however no tax free uplift on death.

There is no credit for tax credits or foreign tax paid by the offshore fund (except that the tax reduces the value of the fund and so reduces the gain). But this is also the case for CGT.

23.10 OIG accruing to individual

It is helpful to consider individuals and trustees separately, though some provisions apply to individuals, trustees and companies alike.[13]

23.10.1 *Charge on individuals, trustees and companies*

Section 761(1) ICTA imposes the charge to tax:

> **Charge to income tax or corporation tax of offshore income gain**
> If a disposal to which this Chapter applies gives rise in accordance with s.758 or Schedule 28 to an offshore income gain, then, subject to the provisions of this section, the amount of that gain—
> (a) shall be treated for all the purposes of the Tax Acts as income arising at the time of the disposal to the person making the disposal, and
> (b) shall be charged—
> (i) to income tax for the year of assessment in which the disposal is made, or
> (ii) to corporation tax under the charge to corporation tax as income for the accounting period in which the disposal is made.

This provision refers to a "person" so it applies in principle to individuals, trustees, companies and PRs.

Section 761(1A) ICTA adds:

> The income tax charged by virtue of subsection (1)(b)(i) above shall be charged on the full amount of the income treated as arising in the year of assessment.

23.11 OIG remittance basis

Section 761(5) ICTA provides a remittance basis for the UK resident

13 No doubt the second Corporation Tax rewrite Bill will put an end to that in 2011.

foreign domiciled individual:

> Subsections (1)(b) and (1A) are subject to s.762ZB (income treated as arising: non-UK domiciled individuals to whom remittance basis applies).

This takes us to s.762ZB ICTA which provides:

> **762ZB Income treated as arising under s.761(1): remittance basis**
> (1) This section applies to income treated as arising under s.761(1) to an individual in a tax year if—
> (a) s.809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for that year, and
> (b) the individual is not domiciled in the UK in that year.
> (2) Treat the income as relevant foreign income of the individual.

This feeds into s.830 ITTOIA which imposes the remittance basis on relevant foreign income.. I refer to this as "**the OIG remittance basis**".

The remittance basis applies even if the offshore fund is a UK situate asset (the CGT situs rules are not relevant) but in practice that will not happen.

So long as the gain is not remitted, the foreign domiciled individual will not care if the gain is a chargeable gain or an OIG, i.e. he will not care whether or not the asset disposed of is an offshore fund.

Section 726ZB continues:

> (3) For the purposes of Chapter A1 of Part 14 of ITA 2007 (remittance basis)—
> (a) treat any consideration obtained on the disposal of the asset as deriving from the income, and
> (b) unless the consideration so obtained is of an amount equal to the market value of the asset, treat the asset as deriving from the income.
> (4) In subsection (3)—
> (a) "the asset" means the asset the disposal of which causes the income to be treated as arising, and
> (b) "the disposal" means the disposal mentioned in para (a).

Section 726ZB(3)(b) is the equivalent of the CGT rule for deemed gains.[14] At first sight it is not clear why s.726ZB(3)(a) is needed. It seems self-evident. There is no equivalent in the CGT charge on gains accruing to individuals. But the a reason will emerge.[15]

23.12 OIG accruing to UK trust

23.12.1 *UK resident trust (not settlor-interested)*

A UK resident trust is in principle subject to income tax on its OIGs.[16] Tax is charged at the trust rate, 40%: s.482 ITA.

23.12.2 *UK resident settlor-interested trust*

An OIG accruing to UK trustees is not "income" in the general sense and in the absence of express provision it would not be fall within s.624 ITTOIA which only applies to income. However s.761(1) directs that the OIG is "treated for all the purposes of the Tax Acts as income" so it does fall within s.624 ITTOIA. Section 624 does not apply in two cases:

(1) If the settlor is not UK domiciled and the OIG is not remitted. The OIG then falls within the s.624 remittance basis.[17]
(2) If the OIG accrues to a non-resident company held by a UK trust.[18]

In these cases the OIG is then chargeable on the trustees after all. But the rate of tax in the absence of s.624 is 40%, so s.624 can only reduce the tax rate (or make no difference).

23.13 OIG non-residence defence

Section 761(2) ICTA provides a territorial limitation for non-residents:

> Subject to subsection (3) below,

14 See 10.25 (CGT disposal not for market value).
15 See 23.18.6 (OIG s.13 remittance basis).
16 See 23.10.1 (Charge on individuals, trustees and companies).
17 See 16.5 (Section 624 remittance basis).
18 See 23.19 (Interaction of anti-avoidance provisions).

> [a] sections 2(1), 10 and 10B of the [TCGA] (persons chargeable to tax in respect of chargeable gains) and
> [b] s.11(2A)(c) [ICTA]
> shall have effect in relation to income tax or corporation tax in respect of offshore income gains as they have effect in relation to capital gains tax or corporation tax in respect of chargeable gains.

Amended as s.761(2) directs, s.2(1) TCGA provides (so far as relevant):

> ... a person shall be chargeable to *income tax* in respect of *offshore income gains* accruing to him in a year of assessment during any part of which he is resident in the UK, or during which he is ordinarily resident in the UK.

This incorporates the CGT residence rules by reference.[19] By implication, a person not resident (and not ordinarily resident) is not chargeable to IT on offshore income gains. I refer to this rule as "**the OIG non-residence defence**".

Section 2 TCGA refers to a "person" so it applies to individuals, trustees, companies and PRs.

23.14 OIG accruing to non-resident trust

Where an OIG accrues to a non-resident trust, the trustees are not subject to tax on the gain. This is for two reasons either of which would be sufficient. Section 761(2) ICTA imposes a territorial limitation. In addition, s.761(7) ICTA disapplies the charge altogether:

> In any case where—
> (a) a disposal to which this Chapter applies is a disposal of settled property, within the meaning of the [TCGA 1992], and
> (b) at the time of the disposal referred to in para (a) above the trustees of the settlement are neither resident nor ordinarily resident in the

19 Section 761(2)(3) ICTA also incorporates s.10 TCGA which would apply if a non-resident carried on a trade through a branch or agency and used the offshore funds for the purposes of the trade. This gives a neat symmetry with the CGT rules but it is hard to imagine that this will ever apply in practice.
Section 1015 ITA could also restrict the territorial scope of the OIG charge, but the rules discussed here leave it no room to operate.

> UK for the purposes of the [TCGA 1992],
>
> subsection (1) above shall not apply in relation to any offshore income gain to which the disposal gives rise.

At first sight s.761(7) seems otiose, but it does have a role: by disapplying s.761(1) it disapplies s.624 ITTOIA for non-resident trusts.

Section 761(8) ICTA provides:

> Nothing in subsection (7) affects the application of this section in relation to an offshore income gain treated as arising by virtue of s.762(3).

This prevents an argument that s.761(7) ICTA disapplies the OIG s.87 charge (though I would not have thought it strictly necessary to say that).

23.14.1 *Section 624 ITTOIA*

An OIG accruing to a non-resident settlor-interested trust is not within s.624 ITTOIA, unlike a UK resident trust. The OIG is normally treated as income under s.761(1) ICTA, but this rule is disapplied for non-resident trusts by s.761(7) ICTA (set out above).

23.15 Outline of OIG anti-avoidance provisions

The rule that non-resident trusts and companies are not subject to tax on their OIGs presents an obvious means of tax avoidance. HMRC might have applied either the income tax TAA provisions or the CGT anti-avoidance provisions to deal with this. In fact they have applied both of them:

(1) Section 726ZA ICTA applies the TAA provisions.
(2) Section 762 ICTA applies the CGT anti-avoidance provisions (with some amendments):
    (a) Section 762(1) ICTA applies s.13 TCGA.
    (b) Section 762(3) ICTA applies s.87 TCGA.

Further rules are needed to deal with the many possible ways in which the anti-avoidance provisions may interact:

(1) Interactions between these IT and CGT anti-avoidance provisions potentially applying to the same OIG; and
(2) Interactions between:
(a) the applicable anti-avoidance provision relating to an OIG and
(b) s.731 or CGT s.87 (where a beneficiary receives a benefit and there is also relevant income or a CGT s.2(2) amount).

23.15.1 *Commentary*

The result of applying two sets of anti-avoidance provisions is so complicated that no-one could expect the rules which I seek to explain below to be applied in practice, except by the very largest trusts with a very large budget for professional advice. It also introduces a full set of anomalies and scope for tax planning.

Although it was the case before the 2008 reforms that both the TAA and the CGT anti-avoidance provisions applied, the 2008 reforms have made both sets of provisions very much more complicated, so that the dual application now presents much more complexity than before.

The drafting of the OIG provisions was even more rushed than the rest of the 2008 legislation, leaving no time even for HMRC to properly consider the issues, let alone for consultation. It seems to me that there can be no more devastating criticism of the rules than an attempt to explain them. The reader who labours through the next part of this chapter is likely to agree that the law ought to be simplified by applying either the income tax or the CGT anti-avoidance rules – CGT would be the better of the two, as OIGs are more like capital gains – but not both.

23.16 OIG TAA provisions

An OIG accruing to a non-resident is not "income" so in the absence of express provision it would not fall within the TAA provisions even if it accrued to a person abroad within s.720 or 731. Section 762ZA(1) ICTA deals with this and thus applies the TAA provisions to OIGs:

> Chapter 2 of Part 13 of ITA 2007 (transfer of assets abroad) applies in relation to an offshore income gain arising to a person resident or domiciled outside the UK as if the offshore income gain were income becoming payable to the person.

It is helpful to distinguish the ordinary income tax transfer of asset rules and the rules as they apply to OIGs. I use the following terminology:

(1) "**OIG s.720**", the provisions of s.720 ITA which apply when a person abroad receives OIGs, deemed to be income within the scope of s.720.

(2) "**OIG s.731**", the provisions of s.731 ITA which apply when the person abroad receives OIGs which are deemed to be income and so relevant income, for the purposes of s.731; this will be contrasted with "**ordinary IT s.731**" which applies where the person abroad receives ordinary income which is relevant income.

Section 762ZA(2) ICTA provides:

> Income treated as arising under that Chapter by virtue of subsection (1) is regarded as "foreign" for the purposes of s.726, 730 or 735 of that Act.

This feeds into s.726 and 735 ITA which impose a remittance basis for OIG s.720 and OIG s.731. The motive defence may also apply. There are only limited differences between the way that sections 720 and 731 work for OIGs and for ordinary income.

23.17 OIG s.13 charge

An OIG is not a chargeable gain, so in the absence of express provision it would not fall within s.13 TCGA. Section 762(1) ICTA deals with this and applies s.13 TCGA to OIGs with modifications:

> Section 13 [TCGA 1992] (chargeable gains accruing to certain non-resident companies) shall have effect in relation to offshore income gains subject to the following modifications—
> (a) for any reference to a chargeable gain there shall be substituted a reference to an offshore income gain;
> (b) for the reference in subsection (7) to capital gains tax there shall be substituted a reference to income tax or corporation tax; and
> (c) paras (b) and (c) of subsection (5) and subsection (8) shall be omitted.

I refer to this as **"the OIG s.13 charge"**. It is necessary to distinguish the CGT s.13 rules and the OIG s.13 rules because the rules (though similar) are not identical. I refer below to:

(1) "**CGT s.13,**" the provisions of s.13 TCGA which apply where CGT chargeable gains accrue to the non-resident company; if the section applies, a CGT chargeable gain accrues to a participator which I call "**the CGT s.13 deemed gain"**.
(2) "**OIG s.13,**" the provisions of s.13 as amended, which apply where OIGs arise to the non-resident company; if the section applies, an OIG accrues to a participator which I call "**the OIG s.13 deemed OIG"**.

Amended as s.762(1) directs, s.13 TCGA provides:

> **Attribution of [OIGs] to members of non-resident companies**
> (1) This section applies as respects *offshore income gains* accruing to a company—
> (a) which is not resident in the UK, and
> (b) which would be a close company if it were resident in the UK.
> (2) Subject to this section, every person who at the time when the *offshore income gain* accrues to the company is resident or ordinarily resident in the UK, and who is a participator in the company, shall be treated for the purposes of this Act as if a part of the *offshore income gain* had accrued to him.
> (3) That part shall be equal to the proportion of the gain that corresponds to the extent of the participator's interest as a participator in the company.
> (4) Subsection (2) above shall not apply in the case of any participator in the company to which the *offshore income* gain accrues where the aggregate amount falling under that subsection to be apportioned to him and to persons connected with him does not exceed one tenth of the gain.
> (5) This section shall not apply in relation to—
> ~~(b) *an offshore income gain* accruing on the disposal of an asset used, and used only—~~
> ~~(i) for the purposes of a trade carried on by the company wholly outside the UK, or~~
> ~~(ii) for the purposes of the part carried on outside the UK of a trade carried on by the company partly within and partly outside the UK, or~~
> ~~(c) *an offshore income gain* accruing on the disposal of currency or of a debt within section 252(1), where the currency or debt is or represents~~

~~money in use for the purposes of a trade carried on by the company wholly outside the UK, or~~

(d) to *an offshore income gain* in respect of which the company is chargeable to tax by virtue of section 10B.

[*Subsections 5A to 7A relate to company distribution relief and company disposal relief and need not be printed here.*]

~~(8) So far as it would go to reduce or extinguish chargeable gains accruing by virtue of this section to a person in a year of assessment this section shall apply in relation to a loss accruing to the company on the disposal of an asset in that year of assessment as it would apply if a gain instead of a loss had accrued to the company on the disposal, but shall only so apply in relation to that person; and subject to the preceding provisions of this subsection this section shall not apply in relation to a loss accruing to the company.~~

(9) If a person who is a participator in the company at the time when the *offshore income gain* accrues to the company is itself a company which is not resident in the UK but which would be a close company if it were resident in the UK, an amount equal to the amount apportioned under subsection (3) above out of the *offshore income gain* to the participating company's interest as a participator in the company to which the gain accrues shall be further apportioned among the participators in the participating company according to the extent of their respective interests as participators, and subsection (2) above shall apply to them accordingly in relation to the amounts further apportioned, and so on through any number of companies.

(10) The persons treated by this section as if a part of an *offshore income gain* accruing to a company had accrued to them shall include the trustees of a settlement who are participators in the company, or in any company amongst the participators in which the gain is apportioned under subsection (9) above, if when the gain accrues to the company the trustees are neither resident nor ordinarily resident in the UK.

(10B) [*This relates to pension schemes and need not be set out here*]

(11) [*This confers relief where tax is paid by the company and need not be set out here]*

(11A) For the purposes of this section the amount of the gain or loss accruing at any time to a company that is not resident in the UK shall be computed (where it is not the case) as if that company were within the charge to corporation tax on *offshore income gains*.

[*Section 13(12) to (15) contain definition and administrative provisions which need not be set out here*]

For a full discussion of CGT s.13, see 39.1 (Gains of non-resident companies). I here concentrate on areas where OIG s.13 is different from CGT s.13.

The most important difference between the two rules is that a CGT s.13 deemed gain is subject to CGT at CGT rates; an OIG s.13 deemed OIG is subject to IT at IT rates. There are other differences.

The deletions in s.13(5)(8) make sense as those CGT rules would not be appropriate for OIG s.13.

DTT relief may apply where a UK resident trustee holds a treaty non-resident company to which an OIG applies: s.79B TCGA disapplies the relief for CGT[20] but not for OIG. Offshore group relief does not apply to OIG s.13 because s.762 ICTA does not incorporate s.14 TCGA.

23.17.1 *Deemed disposal*

If OIG s.13 applies, a participator receives an OIG s.13 deemed OIG. OIG s.13 does not directly impose a charge on that deemed OIG: the deeming feeds into s.761 ITA which imposes the charge when an OIG accrues on the person making the disposal. A further deeming is needed, because the participator to whom the s.13 deemed OIG accrues does not make a disposal. Therefore section 762(5) ICTA provides for a deemed disposal, to bring the deemed OIG into charge under s.761:

> If, by virtue of subsection (1) or (3), offshore income gains are treated as arising to a person, for the purposes of s.761 as it applies in relation to the offshore income gains treat the person as having made the disposal in question.

(The same rule applies for OIG s.87.)

23.17.2 *OIG s.13 remittance basis*

Section 14A TCGA provides the CGT s.13 remittance basis, but this section does not apply for the purposes of OIG s.13. Instead s.762ZB ICTA applies, but the end result is the same. This explains s.762ZB(3)(a) ICTA which provides:

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20 See 41.11.4 (Trust holding treaty non-resident company).

> (3) For the purposes of Chapter A1 of Part 14 of ITA 2007 (remittance basis)—
>
> (a) treat any consideration obtained on the disposal of the asset as deriving from the income

This is the equivalent of s.14A(3)(a) TCGA which provides:

> (3) For the purposes of Chapter A1 of Part 14 of ITA 2007 (remittance basis)—
> (a) treat any consideration obtained by the company on the disposal of the asset as deriving from the deemed chargeable gain

23.18 OIG s.87 charge

An OIG is not a chargeable gain, and so not a s.2(2) amount (trust gain), so in the absence of express provision it would not give rise to a charge under s.87 TCGA. Section 762(3) deals with this and applies the s.87 rules with modifications. Because there are modifications, there are significant differences between OIG s.87 and CGT s.87 rules.

23.18.1 *OIG s.87 charge*

Section 762(3) ICTA incorporates the s.87 TCGA rules in this manner:

> Sections 87, 87A, 87C to 90 and 96 to 98 of, and Schedule 4C to, the 1992 Act apply in relation to OIG amounts as if—
>
> (a) references to s.2(2) amounts (except those in para 7B(2)(b) and (4) of Schedule 4C) were to OIG amounts,
>
> (b) references to chargeable gains (except the one in para 1(5) of Schedule 4C) were to offshore income gains,
>
> (c) references to anything accruing were to it arising[21] (and similar references, except the one in para 1(5) of Schedule 4C, were read accordingly), and
>
> (d) sections 87(4), 88(2) to (5), 89(4) and 97(6) and paras 1(3A), 3 to 7, 8AA, 12 and 13 of Schedule 4C were omitted.

21 The terminology of the Taxes Acts is that CGT chargeable gains *accrue;* but OIGs *arise*. There is no difference in meaning so it seems somewhat pedantic to make the change of terminology *when incorporating the CGT s.87 provisions for OIGs; but it does no harm.* When incorporating ss.2,13 CGT for OIGs there is no equivalent change, but it does not matter.

I will not set out the these statutory provisions, as amended, because the text is just too long. The key provision is s.87(2) TCGA which (amended as s.762(3) directs) provides:

> [2][a] *Offshore income gains* are treated as *arising* in the relevant tax year to a beneficiary of the settlement
> [b] who has received a capital payment from the trustees in the relevant tax year or any earlier tax year
> [c] if all or part of the capital payment is matched (under s.87A as it applies for the relevant tax year) with the *OIG amount* for the relevant tax year or any earlier tax year.
>
> (3) The amount of *offshore income gains* treated as accruing is equal to—
> (a) the amount of the capital payment, or
> (b) if only part of the capital payment is matched, the amount of that part.

It is necessary to distinguish the CGT s.87 rules and the OIG s.87 rules because the rules are not identical. I use the following terminology:

(1) "**CGT s.87**", the provisions of s.87 TCGA which apply when the trust has a "**CGT s.2(2) amount**" (formerly called trust gains); if the section applies, a CGT chargeable gain accrues to a beneficiary which I call "**the S.87 deemed CGT gain**".
(2) "**OIG s.87**", the provisions of s.87 as amended, which apply when the trust has "**OIG amounts**"; if the section applies, an OIG accrues to a beneficiary which I call "**the s.87 deemed OIG**".

For a full discussion of CGT s.87, see 38.1 (CGT s.87). I concentrate here on areas where OIG s.13 is different from CGT s.13. But note one area where the two rules are the same. If a trust with OIG amounts makes a capital payment to a non-resident beneficiary, an OIG is treated as accruing to the beneficiary under OIG s.87(2). But no income tax charge arises since the beneficiary qualifies for the OIG non-residence defence.[22] Thus capital payments to non-resident beneficiaries reduce (or "wash") OIG amounts, as they do for CGT s.2(2) amounts.

22 See 23.13 (OIG non-residence defence).

I deal with the 2008 transitional rules elsewhere because they are best considered together with the CGT s.87 transitional rules.[23]

23.18.2 *"OIG amount"*

Section 762(2) ICTA defines the term "OIG amount":

> (2) If—
> (a) offshore income gains arise to the trustees of a settlement in a tax year, and
> (b) s.87 of the 1992 Act (gains of non-resident settlements) applies to the settlement for that year,[24]
> the OIG amount for the settlement for that year is the amount of the offshore income gains.

"OIG amount" is the OIG equivalent of the CGT concept "s.2(2) amount" (formerly called trust gains) though the definition is not identically worded.[25]

It is necessary to have a different definition, since the definition of s.2(2) amounts (trust gains) caters for trust losses, and for gains within s.86 TCGA; the definition of OIG amounts does not do this because losses are not allowable, and s.86 TCGA does not apply to OIGs.

One (I expect, unintended) consequence of the difference in drafting is that there is no double taxation relief where the OIGs are subject to a foreign capital gains tax.[26]

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23 See 38.22.1 (Pre-2008 OIG amounts); 38.23 (Pre-2008 inter-trust transfer).

24 That is, in short, if the trustees are non-resident: see 38.4 (Non-resident settlement condition).

25 Section 87(4) TCGA provides:
"(4) The section 2(2) amount for a settlement for a tax year for which this section applies to the settlement is—
(a) the amount upon which the trustees of the settlement would be chargeable to tax under section 2(2) for that year if they were resident and ordinarily resident in the UK in that year, or
(b)if section 86 applies to the settlement for that year, the amount mentioned in para (a) minus the total amount of chargeable gains treated under that section as accruing in that year.
(5) The section 2(2) amount for a settlement for a tax year for which this section does not apply to the settlement is nil."

26 See 41.16 (DT reliefs: s.87 TCGA).

The drafter has correctly provided in s.762(3)(d) ICTA that s.87(4) TCGA does not apply for OIG s.87, because it has no role in that context.

23.18.3 *"Capital payment"*

"Capital payment" is defined in s.97(1) TCGA. Section 762(3) ICTA does not amend this. It provides:

> In sections 86A to 96 and Schedule 4C and this section "capital payment"—
> (a) means
> [i] any payment which is not chargeable to income tax on the recipient
> [ii] or, in the case of a recipient who is neither resident nor ordinarily resident in the UK, any payment received otherwise than as income...

Suppose a trust within OIG s.87 makes a capital payment (or what appears to be a capital payment) to a UK resident beneficiary. The definition does not actually work for OIG s.87, since what would otherwise be a capital payment falling within OIG s.87 *is* chargeable to IT under OIG s.87! But for the purposes of OIG s.87 the definition must be taken to read that "capital payment" means:

> [i] any payment which is not chargeable to income tax on the recipient *[apart from OIG s.87]*
> [ii] or, in the case of a recipient who is neither resident nor ordinarily resident in the UK, any payment received otherwise than as income...

I refer to such a capital payment which is subject to income tax under OIG s.87 as an **"OIG capital payment"**.

23.18.4 *Deemed disposal*

If OIG s.87 applies, a beneficiary receives a s.87 deemed OIG. OIG s.87 does not directly impose a charge on that deemed OIG: the deeming feeds into s.761 ITA which imposes the charge when a gain accrues on the person making the disposal. A further deeming is needed, because the beneficiary to whom the s.87 deemed OIG accrues does not make a disposal. Therefore section 762(5) ICTA provides for a deemed disposal, to bring the deemed OIG into charge under s.761:

> If, by virtue of subsection (1) or (3), offshore income gains are treated as arising to a person, for the purposes of s.761 as it applies in relation to the offshore income gains treat the person as having made the disposal in question.

(The same rule applies for OIG s.13.)

23.18.5 *OIG s.87: miscellaneous points*

The deemed disposal rules of Schedule 4B TCGA do not apply to OIGs, but the harsh provisions of Schedule 4C TCGA may apply.

The interest supplement rule in s.91 TCGA applies only to CGT s.87 and not to OIG s.87.

23.18.6 *OIG s.87 remittance basis*

What is the position where a remittance basis taxpayer receives a s.87 deemed OIG? Section 87B TCGA provides the CGT s.87 remittance basis but that section does not apply for the purposes of OIG s.87. Instead s.762ZB ICTA applies and imposes a remittance basis which I call **"the OIG s.87 remittance basis"**. Section 762ZB(3)(a) ICTA provides:

> (3) For the purposes of Chapter A1 of Part 14 of ITA 2007 (remittance basis)—
>
> (a) treat any consideration obtained on the disposal of the asset as deriving from the income

Thus under the OIG s.87 remittance basis, the OIG s.87 charge depends on whether the OIG is remitted, not whether the *benefit* is remitted. This is unlike the rule for the CGT s.87 remittance basis. Of course if the benefit is the distribution of the proceeds of sale of the offshore fund, it comes to the same thing, but that need not necessarily be the case. The benefit might be provided out of other funds. Indeed the benefit might be provided before the OIG amount arises and matched to an OIG amount arising later. It is hard to tell if this rule is deliberate or accidental.

Needless to say there was no indication of the HMRC thinking on the point, either in the EN or other published documents.

23.19 Interaction of anti-avoidance provisions

23.19.1 *Trust with OIG amount and CGT s.2(2) amount*

Suppose a capital payment is made from a trust with OIG amounts and CGT s.2(2) amounts. Section 762(4) ICTA provides:

> Section 87A of the 1992 Act applies for a tax year by virtue of subsection (3) before it applies for that year otherwise than by virtue of that subsection.

In short, OIG s.87 has priority to CGT s.87. Where OIG s.87 applies to a capital payment, CGT s.87 does not: the payment is subject to income tax under OIG s.87 so is not a capital payment for the purposes of CGT s.87.

23.19.2 *Interaction of OIG s.13/87 and s.624 ITTOIA*

Section 762(6) ICTA provides:

> To the extent that an offshore income gain is treated, by virtue of
> [a] subsection (1)[27] or
> [b] subsection (3)[28] above,
> as having arisen to any person resident or ordinarily resident in the UK, that gain shall not be deemed to be the income of any individual for the purposes of any provision of Chapter 5 of Part 5 ITTOIA [the settlement provisions].

Section 762(6)[a] disapplies s.624 ITTOIA where a UK resident settlor-interested trust holds a non-resident company. An OIG accruing to the company is attributed to the trustees under OIG s.13 but it is not attributed to the settlor. At first sight this could never really matter, but it does matter, because the settlor has a right of indemnity against the trustees, but the trustees have no right of indemnity against the company to which the

27 This relates to the OIG s.13 charge; see 23.17 (OIG s.13 charge).

28 This relates to the OIG s.87 charge.

gain accrues (in which they may only have a small minority interest.) In the absence of this rule trustees could find themselves unable to meet the settlor's claim.

Section 762(6)[b] disapplies the settlement provisions (Chapter 5 Part 5 ITTOIA) where a gain accrues to non-resident settlor-interested trust and is attributed to a beneficiary under OIG s.87. As far as s.624 ITTOIA is concerned, this appears to be otiose as that section does not apply to a non-resident trust.[29] But it might apply where a capital payment was made to a minor child of the settlor, as then s.762(6)[b] disapplies s.629 ITTOIA.

23.19.3 *Interaction of OIG s.13 and TAA provisions*

Section 762ZA(1) and (3) ICTA need to be read together:

> (1) Chapter 2 of Part 13 of ITA 2007 (transfer of assets abroad) applies in relation to an offshore income gain arising to a person resident or domiciled outside the UK as if the offshore income gain were income becoming payable to the person....
> (3) Subsection (1) does not apply in relation to an offshore income gain if (and to the extent that) it is treated, by virtue of s.762(1), as arising to a person resident or ordinarily resident in the UK.

In short, the s.13 OIG charge has priority over the OIG TAA provisions.

23.20 Interaction of OIG s.87 and OIG TAA provisions

EN FB 2008 provides:

> 45. From 6 April 2008 most offshore income gains will be chargeable to tax under section 87 or 89(2) TCGA only when a capital payment is matched to the gain in the tax year in which the offshore income gain accrues to the trustees.
> 46. Offshore income gains that are not matched in that year will be chargeable to tax by reason of the provisions relating to the transfer of assets abroad legislation in Chapter 2 of Part 13 of the Income Tax Act 2007.
> 47. The Government will bring forward an amendment to the Finance Bill to ensure that the order of matching offshore income gains before other

29 See 23.14.1 (S.624 ITTOIA).

chargeable gains under sections 87 and 87A of TCGA applies across all years. Chargeable gains accruing in a later year are to be matched with capital payments of that year or later years only where there are no offshore income gains that accrued in an earlier year available for matching.

Section 762ZA(4) ICTA provides:

The following provisions apply if s.762(2) applies in relation to an offshore income gain ("the relevant offshore income gain").

In short, the two provisions which follow – subsections (5) and (6) – apply where an OIG accrues to a non-resident trust.

Section 762ZA(1) and (5) ICTA need to be read together:

(1) Chapter 2 of Part 13 of ITA 2007 (transfer of assets abroad) applies in relation to an offshore income gain arising to a person resident or domiciled outside the UK as if the offshore income gain were income becoming payable to the person.

(5) If—

- (a) by virtue of s.762(3) an offshore income gain is treated as arising in a tax year to a person resident or ordinarily resident in the UK, and
- (b) it is so treated by reason of the relevant offshore income gain (or part of it),

for that and subsequent tax years subsection (1) does not apply in relation to the relevant offshore income gain (or that part).

In short, *if* the OIG amount is matched to a capital payment to a UK resident this disapplies the OIG TAA provisions. I refer to this provision as "**OIG matching relief**". The OIG s.87 charge has priority. This applies even if the OIG s.87 charge is (un)taxed on the OIG s.87 remittance basis because such an OIG is nevertheless treated as arising.

Examples

The following examples are based on this situation:

(1) A non-resident trust is within s.720 (UK resident transferor has power to enjoy.) The motive defence does not apply.

(2) The trust has realised an OIG in year 1 of £1m.

(3) The trust has no relevant income.

Example 1
The trustees make no capital payment to any beneficiary in the year that the OIG accrues

The settlor as transferor is taxed on the OIG under OIG s.720 (subject to the s.720 remittance basis if applicable).

Section 762ZA(6) ICTA prevents a second charge to tax on the same OIG if there is a capital payment in a subsequent tax year. It provides:

> If, by virtue of subsection (1) as it applies in relation to the relevant offshore income gain, income is treated under Chapter 2 of Part 13 of ITA 2007 as arising in a tax year, reduce (with effect from the following tax year) the OIG amount in question by the amount of the income.

Example 2
The trustees make a capital payment of £1m to the settlor in year 1.
The settlor is taxed on the capital payment under OIG s.87 (subject to the s.87 OIG remittance basis).
The TAA provisions are disapplied for the OIG because OIG matching relief applies.
Unless rebasing relief is in point (which is discussed below) it should however make no difference whether it is OIG s.720 or OIG s.87 which is used to tax the settlor.

Example 3
The trustees make a capital payment of £1m to a UK resident beneficiary (not the settlor) in year 1.
The beneficiary is taxed on the capital payment under OIG s.87 (subject to the s.87 OIG remittance basis).
The TAA provisions are disapplied for the OIG.
So the result of the capital payment is to shift the tax charge from the settlor to the beneficiary. This would be particularly important if the beneficiary was a remittance basis taxpayer and the settlor was not. In such a case a capital payment to the beneficiary would be tax saving. The capital payment also affects the quantum of the charge if 2008 rebasing applies.

Planning for trust within s.720 which realises an OIG

In short, it is advantageous for the trustees to make a capital payment matched to an OIG amount where a trust within s.720 realises an OIG if

(1) the settlor is not a remittance basis taxpayer and the a beneficiary is a remittance basis taxpayer; or
(2) if rebasing relief applies.

This planning point will often require a distribution (which need not be a distribution of the OIG) to be made in the year that the OIG arises, but if other capital payments have been made (eg the use of living accommodation) that may suffice as that capital payment may be matched with the OIG. (If there is no time to make a payment in the form of a bank transfer, a resolution of the trustees to exercise their power to make a distribution will suffice. If the figures are not available, a resolution to distribute an amount equal to the offshore income gains will suffice. It may be necessary to have a deed of appointment, or consent of a protector: that depends of course on the terms of the trust.)

23.21 Priority between OIG s.731 and OIG s.87 over same OIG

I turn to consider whether OIG s87 TCGA 1992 takes precedence over OIG s.731.

Having regard to OIG matching relief:

(1) if the OIG amount is matched to a capital payment to a UK resident then (in the words of s.762ZA(5)) an OIG is treated as arising in the year to that beneficiary and
(2) this disapplies OIG s.731.

In short, the OIG s.87 charge has priority over OIG s.731. This applies even if the OIG s.87 charge is (un)taxed on the OIG s.87 remittance basis because the s.87 deemed OIG is nevertheless treated as arising.

The priority sometimes matters because:

(1) the OIG s.87 remittance basis is different from the OIG s.731 remittance basis; and
(2) rebasing relief applies only to OIG s.87.

Examples

The following examples are based on this situation:

(1) A non-resident trust is within s.731 (UK resident beneficiaries) but not within s.720 (transferor has no power to enjoy or else is not UK resident.) The motive defence does not apply.
(2) The trust has realised an OIG in year 1 of £1m.
(3) The trust has no relevant income (leaving aside the OIG).

Example 1

The trustees make a capital payment of £1m to a beneficiary in year 1.
The beneficiary is taxed on the capital payment under OIG s.87 (subject to the s.87 OIG remittance basis).
The TAA provisions are disapplied, ie, the OIG does not become relevant income.

Example 2

(1) The trustees make no capital payment to any beneficiary in the year that the OIG accrues
No-one can be subject to tax in year 1 as OIG s.87 only applies if there is a capital payment and OIG s.731 only applies if there is a benefit (which for practical purposes means the same as a capital payment.)
(2) *The trustees make a capital payment of £1m to a UK resident beneficiary in year 2.*
The beneficiary is in my view taxed on the capital payment under OIG s.87 (subject to the s.87 OIG remittance basis).
I have considered s.762ZA(6) ICTA which provides:

> If, by virtue of subsection (1) as it applies in relation to the relevant offshore income gain, income is treated under Chapter 2 of Part 13 of ITA 2007 as arising in a tax year, reduce (with effect from the following tax year) the OIG amount in question by the amount of the income.

Does this apply in year 1? Only if *income is treated under Chapter 2 of Part 13 of ITA as arising* in year 1. Chapter 2 part 13 uses the expression *income is treated as arising* in s.731 (income treated as arising to a non-transferor) and in s.720 (income treated as arising to a transferor). However these sections do not apply in year 1 So s.762ZA(6) does not apply.

I have considered the argument that income is treated as arising in year 1 to the *person abroad* (the OIG) because of s.762ZA(1). But this is not correct, for such income is not treated as arising under Chapter 2 Part 13. This is confirmed, I think, by s.762ZA(2) ICTA which uses the expression "treated as arising" where the reference is clearly to income treated as arising to the transferor under s.720 or to a beneficiary under s.731.
It follows that all capital payments are taxed under OIG s.87 and not OIG s.731. This is a fair and reasonable result.

23.22 Interaction of OIG s.87 and OIG TAA provisions where motive defence applies

EN FB 2008 provides:

> 46. Offshore income gains that are not matched in that year [the year they arise] will be chargeable to tax by reason of the provisions relating to the transfer of assets abroad legislation in Chapter 2 of Part 13 of the Income Tax Act 2007. *There is an exception to this rule where the motive or purpose defence in sections 736 to 742 applies to the gain.*

The legislation has not however achieved this result. Section 762ZA(6) ICTA disapplies OIG s.87:

> If, by virtue of subsection (1) as it applies in relation to the relevant offshore income gain, income is treated under Chapter 2 of Part 13 of ITA 2007 as arising in a tax year...

We must ask whether "income is treated under Chapter 2 of Part 13 of ITA 2007 as arising" if the motive defence applies. In fact even if the motive defence applies, income is treated as arising *to the person abroad*. Section 762ZA(1) ICTA provides:

> Chapter 2 of Part 13 of ITA 2007 (transfer of assets abroad) applies in relation to an offshore income gain arising to a person resident or domiciled outside the UK as if the offshore income gain were income becoming payable to the person.

But s.762ZA(6) is perhaps intending us to ask if income is treated as arising *to the transferor or to a non-transferor* under s.720 or s.731.

Section 739(2) ITA provides the relief where the motive defence applies to pre-2006 transactions.:

> An individual is not liable for income tax under this Chapter for the tax year by reference to the relevant transactions if the individual satisfies an officer of Revenue and Customs that condition A or B is met.

Section 737(2) ITA is identically worded for post-2006 transactions. Now, even though the individual is not liable for IT, the terms of s.762ZA(6) are still satisfied: "income is treated under Chapter 2 of Part 13 of ITA 2007 as arising in a tax year" even if the individual is not liable for income tax on that income. The result is not absurd, especially since the motive defence may be retrospectively lost by a tainted associated operation. A court may find this too literal an approach. But as the legislation becomes more and more complex (and s.762ZA is as complex as tax can be), it is less and less appropriate to apply anything but a literal interpretation to find what it means.

23.23 OIGs and s.86 TCGA

A settlor of a non-resident trust is not subject to tax on OIGs under s.86 TCGA 1992; s.720 may apply in this case. In a non-resident trust where:

(1) the settlor and spouse are excluded, but
(2) s.86 applies (because the settlor is UK domiciled and the settlor's children are beneficiaries)

it may be attractive for a trust to invest in offshore funds which give rise to OIGs (outside s.86) rather than distributor funds or other assets (within s.86), though to do so does in principle increase the rate of tax on capital payments.

23.24 OIG accruing to a partnership

SII Manual para 6370 provides:

> Where an offshore income gain is realised by a partnership, each partner should be separately assessed in respect of his share of the Schedule D Case VI or ITTOIA 2005 Chapter 8 Part 5 income.

23.25 Computation of CGT chargeable gain on disposal of offshore fund

A disposal for the offshore funds rules is generally also a disposal for CGT. Section 763 ICTA gives relief against a double charge. Section 763(1) sets the scene and provides terminology:

> The provisions of this section apply where a disposal to which this Chapter applies gives rise to an offshore income gain; and, if that disposal also constitutes the disposal of the interest concerned for the purposes of the 1992 Act, then that disposal is in the following provisions of this section referred to as "the 1992 Act disposal".

Section 763(2) sets out the first condition for the relief:

> So far as relates to an offshore income gain which arises on a material disposal (within the meaning of Part I of Schedule 28), subsections (3) and (4) below shall have effect in relation to the 1992 Act disposal in substitution for s.37(1) of that Act (deduction of consideration chargeable to tax on income).

The requirement for relief is that the OIG arises on a "material disposal" within the meaning of part I of schedule 28 ICTA. (The drafter of the offshore fund rules was fond of the word "material" since he used it in an entirely different sense in the expression "material interest".) Assuming one has a material disposal, s.763(2) disapplies s.37(1) TCGA which normally governs the overlap between IT and CGT. It introduces instead new rules in subsections (3)(4).

So the starting point is to find the meaning of "material disposal" which is found in para 1 Sch 28 ICTA:

> In this Part of this Schedule "material disposal" means a disposal to which [this Chapter][30] applies, otherwise than by virtue of s.758.

The exception in s.758 ICTA concerns equalisation arrangements, not discussed here.

30 "*This* Chapter" is a slip for "Chapter V Part 17 ICTA". It appears to be a slip in the 1988 consolidation, as the earlier provisions were correct: para 1 Sch 20 FA 1984.

To see which disposals the chapter applies to, see 23.6 ("Disposal to which this chapter applies"). It is important to note that the chapter may apply to disposals on which no income tax charge arises. A material disposal includes:

(1) A disposal by a non-resident individual, although the OIG non-residence defence applies.
(2) A disposal by a UK resident foreign domiciled individual, although the OIG foreign domicile defence applies.
(3) A disposal by a non-resident trust, although outside the scope of the OIG charge.
(4) A disposal by a non-resident company.

Assuming one has a material disposal, s.763(3) ICTA confers the CGT relief:

> Subject to the following provisions of this section, in the computation of the gain accruing on the 1992 Act disposal, a sum equal to the offshore income gain shall be deducted from the sum which would otherwise constitute the amount or value of the consideration for the disposal.

Thus a disposal of a material interest in an offshore fund will not normally give rise to a chargeable gain.

23.26 Losses

This legislation only applies where there is an offshore income gain. Where a loss arises on the disposal, there is no income tax relief.[31]

The loss will be allowable for CGT if ordinary CGT principles permit.[32]

31 Section 152(8) ITA prevents miscellaneous losses being set against OIGs.

32 Inspectors Manual 4107 (October 2003) provided:

> "Where the disposal on which an offshore income gain arises is also a disposal for the purpose of CGT, the amount of the offshore income gain is deducted from the consideration for the disposal in order to compute the residual chargeable gain (for example, any gain accruing up to 1 January 1984) (see Examples 1 and 2 at IM4108).
> It is important to remember that, for CGT purposes, the indexation allowance is usually available for the entire period of ownership. As a consequence,

This means that foreign domiciled individuals may and non-residents will have no loss relief.[33] The loss (if allowable) is computed on CGT principles (not in accordance with the OIG computation rules of Schedule 28 ICTA).

> where a Part I offshore income gain arises on a disposal, and both the acquisition and disposal take place after 1 January 1984, there will normally be a CGT loss equal to the amount of the indexation allowance (see Example 3 at IM4108). This loss is allowable against other capital gains or may be carried forward under normal rules."

This text was written before the de-indexation of losses in 1993 and ending of indexation relief in 1998. It is relevant as showing that HMRC (correctly) accept the principle that a disposal of offshore funds may give rise to an allowable loss.

33 See 37.1 (Capital losses).

CHAPTER TWENTY FOUR

OFFSHORE FUNDS FROM 1 DECEMBER 2009

24.1 Offshore funds from 1 December 2009

From 1 December 2009 the rules for offshore funds will change entirely.

The FA 2009 contains a new definition of "Offshore Fund". (This is perhaps a tacit admission that the 2007 re-definition was botched.) Will the new definition will be much better? HMRC have issued draft guidance explaining the definition, the length of which (32 pages) says something in itself.

The rules for the taxation of offshore funds will be in the Offshore Funds (Tax) Regulations 2009, the draft of which is 41 pages long.[1] There is no reason from the draft to think that the rules will be any better than the present rules, whether assessed by fairness, simplicity or workability. It is clear that a full discussion of the law will require a very long book to itself.

It would have been better if the new rules had taken effect from 2010/11 rather than halfway through the tax year 2009/10, but there it is.

At the time of going to print, therefore, although it is only four months before the law is promised to take effect, it is not possible to know what the law will be and there is no point trying to write about it. When the relevant material is available, I will put this chapter into TFD Online and readers are invited to download it from there.[2] For notice of this online publication, subscribe to the update announcement list[3] or (use the TFD Online facility) to add the relevant page to your watchlist.

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1 *www.hm-treasury.gov.uk/d/consult_offshorefunds_furthersteps.pdf.*

2 *www.foreigndomiciliaries.co.uk.*

3 *http://lists.mankin.org.uk/mailman/listinfo/jk-announce.*

CHAPTER TWENTY FIVE

ACCRUED INCOME PROFITS

25.1 Accrued income profits – Introduction

This subject needs a book to itself. It would be an unrewarding labour since the rules are "widely ignored by both taxpayers, their advisors and within HMRC".[1]

The following focuses on the questions which most affect foreign domiciliaries and non-residents but one can only approach those questions after understanding how the provisions operate, at least in the commonest cases (I do not consider more specialist topics such as variable rate securities or conversions of securities). The provisions apply on a transfer of securities.

The terms "interest" "settlement day" and "interest period" are defined but the definitions are not considered here.

The AIP provisions do not apply for corporation tax.

25.2 AIP securities

Section 619(1) ITA defines "securities":

> In this Chapter "securities" includes—
> (a) any loan stock or similar security other than an excluded security, and
> (b) shares in a building society which are qualifying shares for the purposes of section 117(4) of TCGA 1992 (qualifying corporate bonds),

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1 Responses to Consultation Exercise on Reform of the AIP, Inland Revenue, December 2004. Reform was promised in 2006 but radical change was rejected and the matter now seems to have been dropped.

but (subject to para (b)) it does not include any shares in a company.[2]

"Excluded securities" are defined in s.619(3), (4), (5) ITA:

> (3) In this section "excluded securities" means—
> (a) national savings certificates (including Ulster Savings Certificates as defined in section 693(7) of ITTOIA 2005),
> (b) war savings certificates,
> (c) uncertificated eligible debt security units as defined in section 986,
> (d) certificates of deposit (see section 1019),
> (e) a security which is a right falling within section 552(1)(c) of ITTOIA 2005 at the time of the transfer in question,
> (f) a security that meets the redemption conditions (see subsection (5)), and
> (g) a security that is a deeply discounted security within the meaning of Chapter 8 of Part 4 of ITTOIA 2005.
>
> (4) But subsection (3)(g) does not include a security if, on its transfer, Chapter 8 of Part 4 of ITTOIA 2005 would apply subject to the rules in sections 454 to 456 of that Act (listed securities held since 26 March 2003).
>
> (5) The redemption conditions are that—
> (a) the security is redeemable,
> (b) the amount payable on its redemption exceeds its issue price, and
> (c) no return other than the amount of that excess is payable on it.

I refer to securities within this definition as "**AIP securities**".

Deeply discounted securities are not AIP securities: thus the DDS rules take priority over the AIP rules.

25.2.1 *Securities "of the same kind"*

Section 619(6) ITA provides:

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2 Section 619(2) ITA adds:
"(2) For the purposes of subsection (1)(a), it does not matter—
(a) whether the security is of the government of the UK, any other government, any public or local authority in the UK or elsewhere, or any company or other body,
(b) whether or not the security is secured,
(c) whether or not the security carries a right to interest of a fixed amount or at a fixed rate percentage of the nominal value of the security, or
(d) whether or not the security is in bearer form."
This can only be for the avoidance of doubt, because it only expresses the usual meaning of "security".

> Securities are treated as being of the same kind for the purposes of this Chapter if they—
> (a) are treated as being of the same kind by the practice of a recognised stock exchange, or
> (b) would be so treated if dealt in on such an exchange.

Para 4040 SAI Manual provides:

> For example, Treasury 5% 2004 is not the same kind as Treasury 5% 2012. This is similar to the capital gains tax concept of securities of a particular class.

25.3 "Transfer"

In outline, the definition is in s.620 ITA:

> **Transactions which are transfers: general**
> (1) References in this Chapter to the transfer of securities are—
> (a) to the transfer of securities by way of sale, exchange, gift or otherwise,
> (b) to the conversion of securities in any case where there is no transfer of the securities within para (a),
> (c) to the redemption of variable rate securities, or
> (d) to a transaction or event treated as a transfer under—
> (i)section 648(1) or (3) (strips of gilt-edged securities),
> (ii) section 649(4) (new securities issued with extra return),
> (iii) section 650(2), (4) or (6) (trading stock appropriations etc),
> (iv) section 651(2) (owner becoming entitled to securities as trustee), or
> (v) section 652(2) (securities ceasing to be held on charitable trusts).
> (2) But subsection (1)(a) does not include—
> (a) the vesting of securities in personal representatives on death, or
> (b) the transfer of a security to which Chapter 8 of Part 4 of ITTOIA 2005 applies subject to the rules in sections 454 to 456 of that Act.

Thus there are altogether eight types of transfer. In this book I consider only the first type. Para 4050 SAI Manual provides:

> The AIS is based on transfers of the legal ownership of securities, not the transfer of the underlying beneficial ownership. Thus, for example,

there is no transfer for the purposes of the AIS if a beneficiary under a trust becomes absolutely entitled as against the trustees to securities forming part of the trust fund.

25.4 Transfer "with accrued interest"

In outline, the definition is in s.623(1) ITA:

> The general rule is that securities are transferred with accrued interest for the purposes of this Chapter if they are transferred with the right to receive interest payable—
> (a) in a case where the settlement day is an interest payment day, on the settlement day, and
> (b) in any other case, on the first interest payment day after the settlement day.

Section 624(1) ITA provides the corresponding definition of a transfer "without accrued interest":

> The general rule is that securities are transferred without accrued interest for the purposes of this Chapter if they are transferred without the right to receive interest payable as mentioned in section 623(1)(a) or (b).

The definitions are comprehensive so every transfer must be either with or without accrued interest, and they are simply English paraphrases of the technical expressions *cum div* and *ex div*.

Para 4020 SAI Manual explains the commercial background:

> **Sales with accrued interest ("cum div")**
> Most sales of marketable securities are "cum div". That is, the buyer is entitled to the next interest due. As an interest payment date on a security approaches, its market price increases to reflect the increase in value of the buyer's right to the interest. In other words, the price reflects accrued interest.
> For example, £100,000 8% Treasury Stock 2002–06 is transferred cum div on 19 April. 14 days' interest has accrued since interest was last paid on 6 April. Accrued interest is £307 (14/365 × 8% × 100,000)...
> **Sales without accrued interest ("ex div")**
> Not all sales of securities are "cum div". This is because gilt-edged securities, and some corporate bonds, have an "ex div" or "ex coupon" date. The next interest coupon is paid to the person who is registered as

> the holder of the security at that date. So if the security is sold in the "ex div" period, the seller collects and keeps the next interest due after the sale. For gilts, the "ex div" period is 7 business days before the coupon date (except for 3 ½% War Loan stock, for which it is 10 business days). Other securities may have a similar, or shorter, "ex div" period.
> Consequently the market price of a security sold "ex div" reflects the fact that the purchaser will own the security for a short period from the date of purchase to the next interest payment date. This is a period over which interest accrues but for which the interest is received not by him but by the seller. The interest accrued over such a period is known as rebate interest. It is treated in the opposite way to the more normal accrued interest associated with a "cum div" sale.
> For example, £100,000 8% Treasury Stock 2002–06 is transferred ex div on 29 March. 7 days' interest has accrued from the day after the transfer to the next interest date, 6 April. Accrued interest is £153 (7/365 × 8% × 100,000). ...

Thus whether a market sale is with or without accrued interest depends only on the date of the sale, whether it is before or after the ex div date. Vendors and purchasers have no say in the matter except by timing the sale. Whether an off-market sale is with or without accrued interest is a matter for the parties to agree.

25.5 Deemed interest payment

Section 632(1) ITA provides:

> **Payment on transfer with accrued interest**
> In the case of a transfer of securities with accrued interest, for the purposes of this Chapter a payment is treated as made by the transferee to the transferor in the interest period in which the settlement day falls.

I refer to this as "**a deemed interest payment**".
Section 632 then defines the amount of that payment. In outline:

> (2) The amount of that payment depends on whether the transfer is under an arrangement by which the transferee accounts to the transferor separately—
> (a) for the consideration for the securities, and
> (b) for gross interest accruing to the settlement day.
> (3) If the transfer is under such an arrangement, the amount of the payment is the amount of gross interest which the transferee accounts for.

(4) If—

(a) the transfer is not under such an arrangement, and

(b) the settlement day is itself an interest payment day for the securities,

the amount of the payment is the amount of interest payable on the securities on that day.

(5) If—

(a) the transfer is not under such an arrangement, and

(b) the settlement day is not an interest payment day for the securities,

the amount of the payment is an amount equal to—

I x (A÷B)

where—

I is the interest payable on the securities on the first interest payment day after the settlement day ("the payment day"),

A is the number of days in the period beginning with the first day on which that interest accrues and ending with the settlement day, and

B is the number of days in the period beginning with the first day on which that interest accrues and ending with the payment day.

Why are there two alternative methods of ascertaining the amount of the deemed interest payment, in subsections (3) and (4)(5)? Para 4140 SAI Manual provides:

> The [deemed interest] payment is the amount of the gross interest accruing to the settlement day, which in most cases is shown separately from the consideration for the securities, under the arrangement (that is, the contract note) by which the transferee accounts to the transferor. This is commonly known as the "clean price" basis.
>
> In exceptional cases – for example, sales off market, gifts, settlements, and deemed transfers – there will be no contract note and it will it be necessary to compute the amount of the [deemed interest] payment. Where this is done, the formula I × A/B is used...
>
> *Example*
>
> Harriet sells corporate bonds to Howard on 15 March 2005. Interest is paid on the bonds on 31 March, 30 June, 30 September and 31 December. Howard will receive the interest coupon due on 31 March 2005, that is, the sale is cum div. The interest Howard receives is £200. If Harriet agrees to sell the bond to Howard for a "clean price" of £10,000 plus an additional £165 for accrued interest, she is taxable on accrued income profits of £165 in 2004–05. Howard will reduce his accrued income profits by £165.
>
> Suppose that, instead, Harriet simply agrees to sell the bond to Howard for £10,165. The relevant interest period is 1 January to 31 March 2005, so B is 90 days. The number of days up to and including 15 March (A)

is 74. So the "accrued amount" is £200 × 74/90 = £164.44. Again, Harriet's taxable accrued income will be £164, and Howard's reduced by £165 (following the principle of rounding in the taxpayer's favour).

In practice the two methods will normally give the same result (as was the case in the HMRC example) though there could be cases where the parties account for accrued interest in some manner which is not quite the same as the formula I × A/B.

It is possible for the amount of the deemed interest payment to be nil, e.g. in the case of a transfer on the interest payment day.

Section 633 ITA contains corresponding rules on a transfer without accrued interest.

25.6 Accrued income profits and losses

Tax is *not* charged on deemed interest payments. But armed with the concept of deemed interest payments, we can turn to "accrued income profits" (and "accrued income losses") which are defined in ss.628 and 629 ITA. In outline:

> **628 Making accrued income profits and losses: general rule**
> (1) This section sets out the general rule for determining whether a person is treated as making accrued income profits or accrued income losses where securities are transferred by or to the person. ...
> (3) A separate calculation is to be made for each kind of security that is transferred by or to the person and for each interest period of each such kind of security.
> (4) Each such calculation is to find—
> (a) the total amount ("A") of the payments treated under this Chapter as made to the person in the interest period in question in respect of transfers of securities of the particular kind, and
> (b) the total amount ("B") of the payments treated under this Chapter as made by the person in that period in respect of such transfers.
> (5) A person is treated as making accrued income profits in an interest period as a result of transfers of securities of a particular kind if A exceeds B.
> (6) A person is treated as making accrued income losses in an interest period as a result of transfers of securities of a particular kind if B exceeds A.

629 Calculating accrued income profits and losses where section 628 applies
(1) If section 628(5) applies, the amount of the accrued income profits treated as made is equal to the excess mentioned in section 628(5).
(2) If section 628(6) applies, the amount of the accrued income losses treated as made is equal to the excess mentioned in section 628(6).

25.7 Charge on AIP income

I refer to the accrued income profits treated as made under s.628 ITA as "**AIP income**".

Section 616 ITA imposes the charge on AIP income:

616 Charge to tax on accrued income profits
Income tax is charged on accrued income profits.

25.8 Relief for accrued income losses

Section 679 ITA confers relief for accrued income losses:

(1) This section applies if—
(a) a person is liable for income tax on interest on securities of any kind which is due at the end of an interest period of the securities,
(b) in that period accrued income losses are made as a result of transfers of those securities, and
(c) the period ends with an interest payment day.
(2) No liability to income tax arises in respect of the interest to the extent that it does not exceed the losses.

Para 4120 SAI Manual provides:

In other words, the losses always reduce the interest subsequently received on those securities, and cannot be used to offset accrued income profits for earlier interest periods or arising on securities which have different interest periods. Where the interest period spans the tax year, losses are therefore not allowed until the interest on the securities is taxed in the following tax year.

What about losses accruing to foreign domiciliaries? EN FB 2008 provides:

80. It is implicit that remittance basis taxpayers are able to obtain relief for accrued income losses. Losses arising on transfers of securities of a particular kind are set against interest received on securities of the same kind at the end of the relevant interest period, and will therefore reduce the individual's relevant foreign income.

For the interaction of loss relief and DTR, see 25.15 (Double taxation relief).

25.9 HMRC examples

Para 4130 SAI Manual provides:

Example 1

Antoinette has £100,000 Treasury Stock 7¾ % 2006, which has interest dates of 8 March and 8 September. She makes the following transactions in the stock.

Transaction	Profit/loss[3]
19 March 2006 sells £100,000	£2,107
21 March 2006 buys £50,000	(£1,361)
12 May 2006 sells £50,000	(£131)
	£615

The aggregate [accrued income] profit is £615, taxable for 2006–07, the tax year in which the interest period ended, even though two of the transactions occur in 2005–06.

Example 2

Jean made the following transactions in securities between 28 February 2005 and 5 April 2006.

19 March 2005	bought £100,000 Treasury Stock 7½% 2006 (interest payment dates 7 June and 7 December)
26 May 2005	bought £50,000 Treasury Stock 7½% 2006 ex div
15 September 2005	sold £20,000 Treasury Stock 7½% 2006
22 September 2005	bought £50,000 Treasury Stock 4½ % 2007 (interest payment dates 7 March and 7 September)

The [accrued income] profits and losses arising on these transactions are:

Transaction date	Interest period	Profit/loss
19 March 2005	08/12/04–07/06/05	(£1,395)
26 May 2005	08/12/04–07/06/05	£82
15 September 2005	08/06/04–07/12/05	£271
22 September 2005	08/09/04–07/03/05	(£778)

3 This means the accrued income profit/loss, not the commercial profit/loss.

The profits and losses for 2005–06 are:

- Loss of £1,313 (1,395 minus 82) against interest of £3,750 (£100,000 × 7½% × ½) received on Treasury Stock 7½% 2006 on 7 June 2005.
- Profit of £271 (Treasury Stock 7½% 2006, interest period 8 June 2005–7 December 2005)
- Loss of £778 against interest of £2,250 received on Treasury Stock 4½ % 2007 on 7 March 2006.

Example 3

See Example 3 in SAIM4160. Joe Smith sells £4,000 unsecured loan stock in Stuffed Dodos Ltd to his Aunt Matilda on 19 August 2005. Interest is payable on 5 April 2005 and 18 April 2006. Neither Joe nor Matilda had any other transactions in securities.

The settlement day falls within the interest period 5 April 2005 to 4 April 2006. Joe is taxable on £79 for 2005–06 in respect of this interest period.

Matilda's loss of £79 is carried forward to 2006–07 to be set against the interest receivable for the period 5 April 2005 to 18 April 2006 (Section 637 ITA 2007 – see SAIM4120).

4160. Examples of transfers with and without accrued interest

Example 1

Anthony has a holding of £100,000 Treasury Stock 8¼;% 2007, a British Government security which pays interest on 16 January and 16 July each year. He arranges for his holding to be sold on the Stock Exchange on 19 March 2006. The contract note from his stockbroker, dated 19 March 2006 contains the following information:

£100,000 Treasury Stock 8¼% 2007 sold @ 114	£114,000
Plus 56 days' accrued interest	£1,315
Payable to you on 20 March 2006	£115,315

The contract note contains all the information that is needed for the purposes of the AIS.

- Treasury Stock 8¼% 2007 falls within the definition of "securities" – Section 619 ITA 2007
- the securities have been transferred, and the transfer is treated as taking place on 19 March because there was a contract for their sale made on that date – Section 620 ITA 2007
- the settlement day for the transfer is 20 March because under Stock Exchange rules bargains in gilt-edged securities are settled on the next business day – Section 674 ITA 2007
- the transfer is with accrued interest because the purchaser gets the right to the interest payable on 16 July 2006, the next interest payment day to fall after 20 March 2006 – Section 623 ITA 2007
- under Stock Exchange rules, accrued interest on gilts is accounted for separately from the bargain price, so the accrued amount is £1,315 – Section 632 ITA 2007
- he interest period in which the settlement day falls is the period 17 January 2006–16 July 2006 – Section 673 ITA 2007.

Accordingly in this interest period Anthony (the transferor) is treated as having received a payment £1,315 and the transferee as having made a payment of £1,315 (Section 632 ITA 2007).

Example 2

Facts as in Example 1, except that the sale takes place on 1 July 2006 which falls within the "ex-dividend" period for the stock. The contract note from the stockbroker shows:

£100,000 Treasury Stock 8¼% 2007 sold @ 114	£114,000
Minus 15 days' rebate interest	£352
Payable to you on 2 July 2006	£113,648

The transfer of securities is treated as made on 1 July 2006. The settlement day is 2 July 2006. The transfer is without accrued interest because this is an "ex-div" sale where the seller retains the right to the interest payable on 16 July 2006 (Section 633 ITA 2007). The rebate amount is £352 and the relevant interest period is that from 17 January–16 July 2006

Accordingly in this interest period Anthony (the transferor) is treated as having made a payment of securities of £352 and the transferee as having received a payment of £352.

Example 3

Stuffed Dodos Ltd is a UK company which has issued unquoted unsecured loan stock paying interest each year on the Tuesday following Easter Day. Thus in 2005 interest is payable on 5 April and in 2006 interest is payable on 18 April. Joe Smith owns £10,000 nominal of this stock and agrees to sell £4,000 to his aunt Matilda. Under the agreement, which was made on 8 July 2005, Matilda is to pay £5,000 for the stock on 19 August. The interest payable on 18 April 2006 is at the rate of £5.50 per £100 nominal (5.5%).

Even though the loan stock is unsecured, it constitutes "securities" for the purpose of the scheme. The securities are treated as transferred on 8 July 2005 – Section 620(3) ITA 2007.

The settlement day is 19 August because that is the day Matilda has agreed to pay for the securities and it falls before the next interest payment day following the agreement – Section 674(3) ITA 2007. The transfer is with accrued interest (Section 623 ITA 2007).

Because the accrued interest is not accounted for separately, in calculating the accrued amount, the formula in Section 632(5) ITA 2007 is used. A is the period from 5 April 2005 to 19 August 2005. B is the period from 5 April 2005 to 18 April 2006. I is the interest applicable to the securities for the period (5.5% × £4,000 = £220). The accrued amount is thus 137/379 × £220 = 79.

The interest period in which the settlement day falls is that from 5 April 2005 to 4 April 2006. Accordingly in that interest period Joe is treated as receiving as payment of £79 and Matilda as having made a payment of £79.

25.10 Excluded persons

The AIP exemptions use the concept of excluded transferor/transferee.
Section 638 ITA provides:

> **Excluded persons: disregard of certain payments and transfers**
> (1) This section applies if there is a transfer of securities in relation to which a person ("P") is an excluded transferor or excluded transferee.
> (2) In determining whether P has made accrued income profits or accrued income losses under section 628 (making accrued income profits and losses: general rule) and the amount of any such profits or losses, no account is to be taken of any payment treated as made by or to P on the transfer.

A person is not an excluded transferor/transferee in isolation. One is excluded in relation to a transfer of securities. An excluded person is broadly outside the AIP scheme.

25.11 AIP non-residence defence

Section 643 ITA provides:

> **Non-residents**
> (1) A person is—
> (a) an excluded transferor in relation to a transfer by the person, and
> (b) an excluded transferee in relation to a transfer to the person,
> if the person is non-UK resident throughout the tax year in which the transfer occurs and is not ordinarily UK resident during that year.

The exemption avoids the AIP charge on UK and foreign AIP securities.[4] It also withholds the AIP relief. A person coming to or leaving the UK might time disposals to obtain AIP relief while UK resident, while making disposals on which a charge would apply while non-resident.

The temporary non-residence rules do not apply. However CGT may fill the gap left by the AIP non-residence defence. The gain on the disposal of AIP securities may be subject to CGT if the CGT temporary non-residence rules apply.

4 Section 1015 ITA (if needed) could also restrict the territorial scope of the AIP charge, but the rules discussed here it no room to operate.

25.12 AIP remittance basis

Section 670A ITA provides:

> (1) This section applies if—
> (a) accrued income profits are made by an individual as a result of a transfer of foreign securities, and
> (b) section 809B, 809D or 809E (remittance basis) applies to the individual for the tax year in which the profits are made.
> (2) Treat the accrued income profits as relevant foreign income of the individual. ...
> (4) For the purposes of this section securities are "foreign" if income from them would be relevant foreign income.

This brings in the remittance basis. The AIP income is fictional, deemed income, which could not be remitted. Accordingly, s.670A(3) ITA provides:

> For the purposes of Chapter A1 of Part 14 (remittance basis)—
> (a) if the individual is the transferor—
> (i) treat any consideration for the transfer as deriving from the accrued income profits, and
> (ii) if on the transfer the individual does not receive consideration of an amount equal to or exceeding the market value of the securities, treat the securities as deriving from the accrued income profits, and
> (b) if the individual is the transferee, treat the securities as deriving from the accrued income profits.

Section 670A(3)(a)(ii) is the equivalent of the CGT rule for deemed gains. EN FB 2008 provides:

> 79. In some cases, a remittance basis taxpayer will make an accrued income profit on a transfer of securities, but will not receive consideration equal to the market value of the securities. Most obviously, this happens where the securities are transferred "ex-div" and the taxpayer is the transferee. It may also happen where the taxpayer is the transferor, and makes a gift of the securities, or where AIS rules treat an event as a transfer (for example, an appropriation of securities to trading stock). In such cases the securities themselves are treated as deriving from the accrued income profits. A charge will arise on the

> taxpayer when they, or some other "relevant person", either brings the securities to the UK (if they are held in bearer form) or remits money or property deriving from the securities.

It follows that the consideration for the transfer of AIP securities with accrued interest will normally be a mixed fund, consisting in part of AIP income, and the mixed fund rules will apply. There are three separate reasons why one cannot effectively segregate the AIP income from the other proceeds of the sale.

Firstly, assume that:

(1) P will pay a single sum for the security to V's broker (the total price.)
(2) The broker will then divide the total price into two parts (accrued interest and clean price) and pay the two parts into two separate accounts of the vendor.

HMRC may reasonably argue that there is already a mixed fund on receipt of the payment by the broker on behalf of the client at stage (1), and the broker's act in transferring the single payment into two accounts brings into effect the mixed fund rules. In theory we could avoid this difficulty if P could pay two separate sums, one in respect of accrued interest and one in respect of the clean price; but in practice on a market sale that would not be practical.

Secondly, HMRC would argue that the AIP income is to be regarded as a fictional, notional amount which is distinct from the sum paid for the accrued interest. It is rather like the CFC income in *Brikom*.[5] 5. Even if that were wrong, however, the proposal faces a third and I think insuperable obstacle in s.670A(4) ITA, which provides:

> For the purposes of Chapter A1 of Part 14 (remittance basis)
> (a) if the individual is the transferor –
> (i)treat *any* consideration for the transfer as deriving from the accrued income profits.

Thus even if (contrary to my view) the amount that V, the transferor, received for the accrued interest did constitute the AIP income, the effect of s.670A(4) is that any consideration for the securities sold by V is treated

5 See 41.6 (The characterisation issue).

as deriving from the AIP income.

However HMRC do not take that view. The RDR Manual provides:

> **Accrued Income Scheme**
> Where a security is sold with accrued income and the proceeds paid into an account, the part of the proceeds representing accrued income will be taxable as income and subject to income tax under the Accrued Income Scheme (AIS). ...
> In these circumstances, for consistency of treatment between the AIS and the remittance basis regime, HMRC will follow the tax treatment delivered by the AIS and accept that an "income amount" could be transferred to a separate "income account" immediately upon transfer, i.e. the proceeds would need to be "split" before reaching the individual. This "income" could then fall to be identified and taxed as such, without creating a mixed fund. To the extent that the remainder of the proceeds consisted of capital or UK or non-taxable income as oppose to, say, untaxed foreign income or gains originally used in the purchase of the security ... they could therefore be separately identified and remitted as such.

25.12.1 *Tax planning to avoid AIP income*

A person selling securities on the market could avoid receiving deemed interest payments (and so avoid AIP income) by selling on the interest payment day, or in the ex div period. That is not a practical investment strategy for fund managers, since the interest payment day typically only occurs every 6 months and the ex div period is short.

Similarly a person buying securities on the market could avoid receiving deemed interest payments (and so avoid AIP income) by buying on the interest payment day, or outside the ex div period. That is less of a restriction for fund managers, since ex div periods are relatively short, but still a serious inconvenience. Off-market sales allow more flexibility

The alternative is to arrange that a person makes deemed interest payments equal to the amount of deemed interest payments that he receives. That is, amount B in the computation in s.628 (see para 22 above) equals (or exceeds) amount A. This is possible to arrange, by

(1) a purchase of a security cum div just before the ex div date followed by
(2) a sale of a security just after the ex div date.

This could be done on successive days; the CGT rule disregarding sales and purchases of securities of the same kind within 30 days (s.106A TCGA 1992) does not apply here. So there need be only limited market exposure.

If an individual bought and sold securities in this way, HMRC might possibly seek to serve a notice under s.682 ITA (transactions in securities) but this is not the sort of transaction at which those provisions are aimed. In relation to a trust, however, this problem does not arise, since the person who receives a tax advantage (the settlor or beneficiary) does not receive the proceeds of sale of the securities.

This arrangement would need to be done for each interest period and for each kind of security, if it is to be fully effective. The main question is whether the dealing costs justify the tax saving

This proposal does not apply to variable rate securities because there is no equivalent relief for them: see s.635 ITA.) In practice I expect that securities commonly dealt in will not be variable rate securities. The definition is in s.627 ITA:

> (1) For the purposes of this Chapter securities are "variable rate securities" unless their terms of issue provide that throughout the period from issue to redemption (whenever redemption might occur) they are to carry interest at a rate which falls into one, and one only, of the categories specified in subsection (2).
> (2) The categories are
> (a) a fixed rate which is the same throughout the period,
> (b) a rate which bears the same fixed relationship to a standard published base rate throughout the period, and
> (c) a rate which bears the same fixed relationship to a published index of prices throughout the period.
> (3) In subsection (2) "published index of prices" means the retail prices index or any similar general index of prices which is published by the government of any territory outside the United Kingdom or by an agent of such a government.

25.12.2 *Position before 2008 and transitional rules*

Until 2008/09 a foreign domiciled individual was wholly outside the scope of the AIP rules on foreign securities.

Para 160 Sch 7 FA 2008 provides:

> The amendments made by paras 156 to 159 have effect in relation to transfers of securities where the settlement day is on or after 6 April 2008.

The new rules therefore catch AIP securities even though held before the law changed in 2008.

25.13 Settlor-interested trusts

25.13.1 *UK resident settlor-interested trusts*

Section 667(1) ITA provides:

> If the trustees[6] of a settlement are treated as making qualifying accrued income profits,[7] those profits are to be taken to be income arising under the settlement for the purposes of Chapter 5 of Part 5 of ITTOIA 2005 (settlements: amounts treated as income of settlor).

I am not sure if this is necessary, but perhaps it could have been argued that although "tax is charged on accrued income profits" (s.616) such profits are nevertheless not "income arising under a settlement".

25.13.2 *Non-resident trusts*

In the absence of express provision, AIP income of non-resident trustees would not fall within the settlement provisions because the trustees would qualify for the AIP non-residence defence. Section 667 ITA provides:

> (2) Subsection (3) applies if the trustees of a settlement—
> (a) are non-UK resident or domiciled outside the UK throughout a tax year in which an interest period or part of an interest period falls, and
> (b) would have been treated as making an amount or an additional

6 Defined in s.667(4)(b) ITA.

7 Defined in s.667(4)(a) ITA:

> "'qualifying accrued income profits' means accrued income profits which are treated as made—
> (i) under section 628(5), or
> (ii) under section 630(2) in respect of a transfer of variable rate securities."

The drafting is misleading because as far as I can see all accrued income profits are "qualifying" accrued income profits.

> amount of qualifying accrued income profits in the interest period if the trustees had been UK resident or domiciled in the UK during a part of each such tax year.
>
> (3) The amount or additional amount of qualifying accrued income profits that the trustees would have been treated as making is to be taken to be income arising under the settlement for the purposes of Chapter 5 of Part 5 of ITTOIA 2005.

Thus the AIP income of a settlor-interested trust is within the scope of s.624 ITTOIA. However, the s.624 remittance basis can apply.

Non-resident trustees would not qualify for AIP loss relief,[8] so s.680 ITA extends the relief:

> (1) This section applies if—
> (a) the trustees of a settlement are non-UK resident or domiciled outside the UK throughout a tax year in which an interest period or part of an interest period of securities falls,
> (b) the trustees' income is or includes interest from those securities,
> (c) the interest falls due at the end of that interest period, and
> (d) had the trustees been UK resident, or domiciled in the UK, during a part of each such tax year the interest would have been wholly or partly exempt from income tax under section 679.
>
> (2) No liability to income tax arises as a result of Chapter 5 of Part 5 of ITTOIA 2005 (settlements: amounts treated as income of settlor) in respect of so much of the interest as would have been exempt from income tax under section 679.

The references to domicile in ss.667 and 680 ITA are not appropriate after the 2008 reforms, though they do no harm.

25.14 Transfer of assets abroad

In the absence of express provision, AIP income would not fall within the TAA provisions because the person abroad would qualify for the AIP non-residence defence (assuming the person abroad is non-resident). However, s.747 ITA deals with this:

8 See 25.8 (Relief for accrued losses).

> (1) This subsection applies if a person—
> (a) would have been treated as—
> (i) making qualifying accrued income profits, or
> (ii) making qualifying accrued income profits of a greater amount,
> in an interest period, but
> (b) is not so treated because of being resident or domiciled outside the UK throughout any tax year in which the interest period (or part of it) falls.
> (2) If subsection (1) applies, this Chapter applies as if the amount which the person would be treated as making or, as the case may be, the additional amount were income becoming payable to the person.
> (3) Accordingly, any reference in this Chapter to income of (or payable or arising to) a person abroad must be read as including a reference to such an amount.

It has been suggested that this leaves a gap where AIP securities are held by a non-resident company. Section 747(1) ITA applies only if the company would have fallen within the AIP rules but did not do so "because of being resident outside the UK". But if the company had been UK resident, it would be within the charge to corporation tax and outside the scope of AIP.[9] That is correct on a literal construction. However, the context shows that the deeming is not intended to be applied that way, and a comparable argument in a CGT context was resoundingly dismissed in *de Rothschild v Lawrenson* 67 TC 300 ("I do not believe that our processes of statutory construction are so wanting in technique and imagination ...").

The reference to domicile is inapt but it does no harm.

The person abroad (if non-resident) would not qualify for AIP loss relief,[10] so s.747(4)(5) extends the relief:

> (4) This subsection applies if income consisting of interest which falls due at the end of an interest period—
> (a) would have been income as respects which a person is entitled to an exemption, or an exemption of a greater amount, from liability to income tax under section 679 (interest on securities involving accrued income losses: general), but

9 See s.710(1A) ICTA.

10 See 25.8 (Relief for accrued income losses).

(b) is not such income because it is income of a person who is resident or domiciled outside the UK throughout any tax year in which the interest period (or part of it) falls.

(5) If subsection (4) applies, for the purposes of this Chapter the interest is treated as reduced by the amount of the exemption or, as the case may be, the additional exemption.

25.14.1 *Definitions*

Section 747 ITA provides definitions for s.747:

(6) In this section—

(a) expressions which are also used in Chapter 2 of Part 12 (accrued income profits) have the same meaning as in that Chapter (but see subsection (7)), and

(b) "qualifying accrued income profits" means accrued income profits which are treated as made—

(i) under section 628(5), or

(ii) under section 630(2) in respect of a transfer of variable rate securities.

(7) In the case of qualifying accrued income profits within sub-paragraph (ii) of the definition of that expression in subsection (6)(b)—

(a) references in subsection (1)(a) to making qualifying accrued income profits in an interest period are to be read as making them in the tax year in which the settlement day falls, and

(b) the reference in subsection (1)(b) to the interest period is to the period—

(i) beginning with the day after the last day of the only or last interest period of the securities, and

(ii) ending with the settlement day.

The expression "qualifying" accrued income profits is misleading because as far as I can see, all accrued income profits are qualifying.

25.14.2 *Section 731 ITA*

Suppose a person abroad is treated as receiving AIP income. The amount is certainly "income" for TAA purposes, but it is considered that it is not relevant income for s.731 purposes:

(1) The AIP income is fictional income
(2) One cannot say that fictional income "can" be applied for the benefit of any beneficiaries.

The proceeds of the AIP securities can be used for that purpose, but that is not the same income.[11]

HMRC may argue that the proceeds of the API securities do constitute the income (difficult to sustain); or that one should carry through the deeming:[12] if the person abroad is treated as receiving income, the (deemed) income must be treated as if it can be used to benefit beneficiaries (even though it does not exist).

If that is right, how would the rule that distributed income is not relevant income[13] operate in this context? In order to distribute the AIP income would it be necessary to distribute the entire proceeds of the transfer (sale) of the security? Perhaps the matter is analogous to the DDS scheme.[14] Then the only way to avoid relevant income by distribution would be to distribute the entire proceeds of the securities.

Another difficulty with this view is that it does not explain how to deal with AIP loss relief. This tends to support the view that deemed AIP income is outside the scope of s.731.

25.15 Double taxation relief

In the absence of express provision there would be no DT relief, as the AIP income is not taxable in the other state. Section 807(1) ICTA provides relief:

> In any case where—
> (a) a person is treated under section 628(5) of ITA 2007 as making accrued income profits in an interest period; and
> (b) assuming that, in the tax year in which the accrued income profits are treated as made by virtue of section 617(2) of that

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11 See 41.6 (Characterisation). The same point arises for stock dividends; see 19.14 (Stock dividends).

12 For the general approach to deeming provisions, see 45.11.1 (Construction of deeming provisions).

13 See 19.21 (Relevant income of trust distributed as income in year it arises) to 19.25 (Distributed income: HMRC view).

14 See 26.10.1 (Section 731 ITA).

Act, he were to become entitled to any interest on the securities concerned, he would be liable in respect of the interest to tax chargeable under ITTOIA 2005 on relevant foreign income; and

(c) he is liable under the law of a territory outside the UK to tax in respect of interest payable on the securities at the end of the interest period or he would be so liable if he were entitled to that interest,

credit of an amount equal to the relevant proportion of the accrued income profits shall be allowed against any UK income tax computed by reference to the accrued income profits, and shall be treated as if it were allowed under section 790(4).

In this subsection the relevant proportion is the rate of tax to which the person is or would be liable as mentioned in paragraph (c) above.

Section 807(2) ICTA restricts DTT relief where there is relief for accrued income losses:[15]

In any case where—

(a) a person is entitled to credit against UK tax under section 790(4) or any corresponding provision of arrangements under section 788; and

(b) the tax is computed by reference to income consisting of interest which falls due on securities at the end of an interest period and as respects which the person is entitled to an exemption from liability to income tax under section 679 of ITA 2007;

then the amount of that credit shall be a proportion of the amount it would be apart from this subsection, and the proportion is to be found by applying the formula—

where—

I is the amount of the interest; and

R is the amount of the exemption.

(3) Where the person entitled to the credit is an individual, subsection (2) above does not apply unless the interest arises from securities to which the person either became or ceased to be entitled during the interest period.

(4) Where section 811(1) applies to any income and, if credit were allowable in respect of it the credit would be reduced by virtue of subsection (2) above, section 811(1) shall have effect in relation to the income as if the reference to any sum paid in respect of tax on it were a

15 See 25.8 (Relief for accrued income losses).

reference to the amount which would be the amount of the credit if it were allowable and subsection (2) above applied.
(5) Expressions used in this section and in Chapter 2 of Part 12 of ITA 2007 (accrued income profits) have the same meaning as in that Chapter.

The SAI Manual provides:

4370. Double taxation relief
Where an AIS charge arises on a foreign stock on which the interest would have suffered foreign tax eligible for credit relief if interest had been received, credit for foreign tax is allowable for the lower of

- the rate of UK tax charged on the accrued income profit, and
- the rate of foreign tax suffered on the interest payable at the end of the interest period for which the charge arises.

If there is an accrued income loss to be set against foreign interest, reduce the credit for foreign tax in the proportion which the allowance bears to the interest.
Example
Taxpayer holds foreign stock on which the interest suffers tax eligible for credit at 15%. Interest paid on 30 June and 31 December.
In the interest period to 30 June 2005, the taxpayer makes transactions resulting in an AIS loss of £200. He receives interest (gross) of £1,000 less £150 foreign tax.
In August 2006 he sells the entire holding and there is an AIS profit of £300. He is liable to UK tax at 22%. His double taxation relief is as follows

Foreign interest		£1,000	
Less Accrued Income relief		£200	
		£800	
Foreign tax deducted	£150		
Credit restricted to	£1000–£200 × £150/£1000		= £120
Accrued income profit			£300
Allow credit for foreign tax			
on AIS charge £300 @ 15%			= £45
Total double taxation relief £120 + £45			= £165

The double taxation relief given can exceed the foreign tax suffered (£165 exceeds the £150 suffered).

25.16 Interaction with CGT

Section 119(1) TCGA disapplies the normal CGT rules in ss.37, 39

TCGA:

> (1) Where there is a transfer of securities within the meaning of Chapter 2 of Part 12 of ITA 2007 (accrued income profits)—
> (a) if a payment is treated as made to the transferor under section 632 of that Act or by the transferor under section 633 of that Act, section 37 shall be disregarded in computing the gain accruing on the disposal concerned;
> (b) if a payment is treated as made by the transferee under section 632 of that Act or to the transferee under section 633 of that Act, section 39 shall be disregarded in computing the gain accruing to the transferee if he disposes of the securities;
> but subsections (2) and (3) below shall apply.

Section 119 TCGA goes on to set out its own rules:

> (2) Where the securities are transferred with accrued interest (within the meaning of that Chapter)—
> (a) if a payment is treated as made to the transferor under section 632 of ITA 2007, an amount equal to the amount of that payment shall be excluded from the consideration mentioned in subsection (8) below;
> (b) if a payment is treated as made by the transferee under that section, an amount equal to the amount of that payment shall be excluded from the sums mentioned in subsection (9) below. ...
> (8) The consideration is the consideration for the disposal of the securities transferred which is taken into account in the computation of the gain accruing on the disposal.

Section 119(3)(9) contains corresponding rules for a transfer without accrued interest:

> (3) Where the securities are transferred without accrued interest (within the meaning of that Chapter)—
> (a) if a payment is treated as made by the transferor under section 633 of ITA 2007, an amount equal to the amount of that payment shall be added to the consideration mentioned in subsection (8) below;
> (b) if a payment is treated as made to the transferee under that section, an amount equal to the amount of that payment shall be added to the sums mentioned in subsection (9) below...
> (9) The sums are the sums allowable to the transferee as a deduction

from the consideration in the computation of the gain accruing to him if he disposes of the securities.

25.17 Unremittable transfer proceeds

EN FB 2008 provides:

> 341... Sections 835 [ITTOIA] (relief for delayed remittances), 836 (relief for delayed remittances: backdated pensions) and 837 (claims for relief on delayed remittances) are considered obsolete, and the opportunity is being taken to repeal them.

The removal of obsolete clutter from the tax code is to be welcomed. Unfortunately the person responsible for this reform overlooked that the same relief for delayed remittances was set out separately in relation to the accrued income scheme in s.668–670 ITA. Needless to say, there was no consultation. The relief is not important enough to be discussed here (I doubt if it is ever used). No doubt it will be repealed sooner or later but its accidental survival does illustrate the ramshackle state of UK tax law.

CHAPTER TWENTY SIX

DEEPLY DISCOUNTED SECURITIES

26.1 DDS – Introduction

This subject needs a book to itself. The following focuses on the questions which most affect foreign domiciliaries and non-residents. The SAI Manual has some useful material which is not set out here.

In outline the charge is on the profits on the disposal of a deeply discounted security ("DDS").

26.2 Meaning of "deeply discounted security"

26.2.1 *"Security"*

SAI Manual para 3010 states:

> The term 'security' is not defined in the legislation. It may be taken to have a broad meaning comparable to the definition in TCGA Section 132(3)(b) (CG53420) ...

26.2.2 "Deeply discounted"

In outline the definition is in s.430 ITTOIA:

> **430 Meaning of "deeply discounted security"**
> (1) The general rule is that a security is a "deeply discounted security" for the purposes of this Chapter if, as at the time it is issued, the amount payable on maturity or any other possible occasion of redemption ("A") exceeds or may exceed the issue price by more than A x 0.5% x Y, where Y is the number of years in the redemption period or 30, whichever is the lower.
> (2) If the redemption period is not a number of complete years, for the

purposes of subsection (1) the incomplete year is expressed as twelfths, treating each complete month and any remaining part of a month as one-twelfth.
(3) In this section "redemption period" means the period between the date of issue and the date of the occasion of redemption in question.
(4) Interest payable on an occasion of redemption is ignored in determining for the purposes of this section the amount payable on that occasion.

SAI Manual para 3020 gives three examples:

Example 1
Company A issues securities for £1,000 which are redeemable in 10 years time for the subscription amount increased by the percentage movement in the Retail Price Index over the same period. As the linkage to the RPI may give more than a 5% increase in value (10 years × 0.5%) over that period, the securities are deeply discounted securities.
Example 2
Company B issues a 12-month security for £950. It is redeemable for £950 at maturity or, depending on events, for £1,000 after 6 months. The occasion of early redemption is not disregarded under Section 431 ITTOIA 2005 (SAIM3030). The difference between the issue and early redemption prices is more than £2.50 (£1,000 × 0.5% × 6/12). The security is therefore a DDS.
Example 3
Bank C issues a 5-year security that is linked to the FTSE 100 share index. Each security has a nominal value to £100. If the index rises, the investor receives on redemption £100 multiplied by the percentage rise in the index. For example, the index has risen to 150% of its starting value, the investor receives £150. If the index falls, the investor is guaranteed to receive back his or her £100, so the security is not an excluded indexed security (SAIM3050). Since the security may give more than a 2.5% increase in value over the period (5 years × 0.5%), it is a DDS, even though there is no certainty as to the redemption amount.

26.2.3 *Securities dealt with under other regimes*

Section 432 ITTOIA provides:

Securities which are not deeply discounted securities
(1) The following are not deeply discounted securities—

(a) shares in a company,
(b) gilt-edged securities that are not strips,
(c) life assurance policies, and
(d) capital redemption policies.[16]

The rules for excluded indexed securities are not discussed here: see ss.432(2), 431(5) and 433 ITTOIA.

26.3 Meaning of "disposal"

Section 437 ITTOIA provides:

> **437 Transactions which are disposals**
> (1) References in this Chapter to the disposal of a deeply discounted security are—
> (a) to its redemption,
> (b) to its transfer by sale, exchange, gift or otherwise, including a transfer treated as made by subsection (3), and
> (c) so far as not covered by para (a) or (b), to its conversion under its terms into shares in a company or other securities (including other deeply discounted securities).
> (2) The person treated as making a disposal is—
> (a) in the case of a disposal within subsection (1)(a), the person entitled as the security's holder to any payment on the disposal,
> (b) in the case of a disposal within subsection (1)(b), the transferor, and
> (c) in the case of a disposal within subsection (1)(c), the person who would be entitled as the security's holder to any payment on the disposal, if such a payment were made.
> (3) A person who dies while entitled to a deeply discounted security is treated as transferring it immediately before death to the personal representatives.

26.4 Meaning of "profit"

Section 439 ITTOIA provides:

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16 Section 432(3) ITA provides:
"In this section "capital redemption policies" has the same meaning as in Chapter 9 of this Part (see section 473(2))."

439 Calculating the profit from disposals
(1) A person's profit on a disposal is the amount by which the amount payable on the disposal exceeds the amount paid by the person to acquire the security.
(2) No account is to be taken of any incidental expenses incurred in connection with the disposal or acquisition.

I refer to this as the DDS profit. The DDS profit is greater than a chargeable gain on a disposal because expenses are disallowed.

26.4.1 *Deemed DDS profit*

Section 440 ITTOIA provides:

440 Market value disposals
(1) On the disposal of a deeply discounted security by a transfer of a kind specified in subsection (2), for the purposes of this Chapter an amount equal to the market value at the time of the disposal is treated as payable.
(2) The transfers are—
(a) a transfer made otherwise than by a bargain at arm's length,
(b) a transfer between connected persons,
(c) a transfer for a consideration which is not wholly in money or money's worth,
(d) a transfer treated as made by section 437(3) (death), and
(e) a transfer by personal representatives to a legatee. ...

I refer to the profit on a disposal within this section as "**deemed DDS profit**".

26.5 Charge to tax on DDS

Sections 427 and 428 ITTOIA impose the charge:

427 Charge to tax on profits from deeply discounted securities
(1) Income tax is charged on profits on the disposal of deeply discounted securities.
(2) The profits are treated as income for income tax purposes if they would not otherwise be income.
428 Income charged
(1) Tax is charged under this Chapter on the full amount of profits

arising in the tax year.
(2) The profits on a disposal are to be taken to arise when the disposal occurs.

26.6 DDS remittance basis

Section 428(3) ITTOIA brings in the remittance basis for a DDS outside the UK:

> If the profits arise on a disposal of securities that are outside the UK—
> (a) they are treated for the purposes of section 830 (meaning of "relevant foreign income") as arising from a source outside the UK, and
> (b) subsection (1) is subject to Part 8 (foreign income: special rules).

The section uses the words "treated as" because DDS income does not have a source, at least in the traditional sense.[17]

How does one decide whether a security is "out of the UK"? In the HMRC view the test is the residence of the issuer. Inspectors Manual para 1541 provided:

> Where the security was issued by a UK resident any profit is assessable under Case III of Schedule D. Where the security was issued by a non-UK resident, any profit is assessable under Case IV of Schedule D.

This is not obviously right, but it is as good a test as any other and (in relation to a non-resident issuer) at least we should know where we stand.[18] This passage is omitted in the SAIM but there is no indication to suggest that HMRC practice has changed.

An alternative approach is to say that a security is in the UK if income from it has a UK source and out of the UK if income from it has a non-UK source.[19] This will usually come to the same thing. Because the rules

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17 See 11.4.1 (Location of source of income when there is no source).

18 The position if the issuer changes residence is less clear, but perhaps this does not arise in practice.

19 Contrast the AIP scheme, where the test is whether income from the security has a foreign source: see 25.12 (AIP remittance basis). However, the two cases are not the same, because a DDS may not yield any income, so the question whether income from the DDS has a foreign source would be a hypothetical question.

concerning the location of the source of interest are so unclear, it is impossible to say in what (if any) circumstances the result would be different from applying a residence of the issuer test.[20]

Strictly, one cannot segregate income from capital (for no identifiable part of the proceeds represents the income). But since HMRC do not apply that rule for the accrued income scheme[21], they should logically not take the point in this context either. There is however no discussion in the RDR Manual.

A deemed DDS profit (e.g. on a gift) cannot be remitted and so is tax free.[22]

26.7 UK resident trust

Section 457 ITTOIA provides:

> (1) This section applies if profits are taken to arise on a disposal of a deeply discounted security by trustees.
> (2) For the purposes of Chapter 5 of Part 5 (settlements: amounts treated as income of settlor), the profits are to be taken to be income arising under the settlement from the security. ...

Thus for UK resident trusts the profit is:

(1) within the scope of s.624 ITTOIA (settlor-interested trusts); or
(2) subject to tax at 40%.

26.8 Non resident trust: s.624

Section 458(1) ITTOIA provides:

> Tax is not charged under this Chapter if the disposal is made by the trustees of a settlement[23] and they are non-UK resident.

20 But see 11.13.5 (Interest from securities).

21 See 25.12 (AIP remittance basis).

22 The CGT rule does not apply here; see 9.21 (CGT disposal not for market value).

23 Settlement" here means settlement-arrangement: see s.458(3) which provides:
> "In this section "settlement" has the same meaning as in Chapter 5 of Part 5 (see section 620)."

Non-resident trusts are not subject to tax on DDS, whether UK or foreign. It is not clear whether s.624 applies to non-resident settlor-interested trusts but the TAA provisions may apply.

26.9 Non-resident individual

Section 368 ITTOIA previses the necessary exemption for non-residents.[24] In short non-resident individuals are not chargeable if the security is out of the UK. They are theoretically chargeable if the security is in the UK but see 31.1 (Limit on liability for non-residents).

26.10 Transfers of assets abroad

Section 459 ITTOIA provides:

> (1) This section applies if profits are taken to arise on the disposal of a deeply discounted security by a person resident or domiciled outside the UK ("A").
> (2) For the purpose of determining whether an individual ordinarily UK resident is liable for income tax in respect of the profits, Chapter 2 of Part 13 of ITA 2007 (transfer of assets abroad) has effect as if the profits, when arising, constituted income becoming payable to A.
> (3) For this purpose it does not matter if A is not liable to income tax under this Chapter because of section 458 (non-UK resident trustees).

This brings DDS profits within the scope of the TAA provisions.

26.10.1 *Section 731 ITA*

The charge is on the actual profit, not a fictional profit. The proceeds of the disposal represent that profit.

How does the rule that distributed income is not relevant income[25] operate in this context? Is it necessary merely to distribute an amount equal to the DDS profit or is it necessary to distribute the entire proceeds of the transfer (sale) of the security? The matter is analogous to the CGT

24 See11.14 (Why does location of source matter?).

25 See 19.21 (Relevant income of trust distributed as income in year it arises) to 19.25 (Distributed income: HMRC view).

issue which arose when a UK resident foreign domiciled beneficiary sold a non-UK situate asset and realised a chargeable gain. Prior to the 2008 mixed fund rule, if the individual remitted (say) one-half of the proceeds of sale, he was regarded as remitting one-half of the gain.

Inspectors Manual para 1567 explained:

> This is because, whilst the income content of any fund is a separate and distinguishable part of that fund, a capital gain is merely part of the whole proceeds of a disposal transaction that has no separate identifiable existence within those proceeds.

The same reasoning would apply here. Thus the only way to avoid relevant income by distribution would be to distribute the entire proceeds of an arm's length disposal. It is conceivable that HMRC will not apply the law on this point strictly, but do not rely on this without clearance.

If there are only fictional profits, because the market value rule applies[26] then s.731 does not apply because fictional income cannot be used to benefit a beneficiary, so it cannot be relevant income.

26.11 Non-resident company

Section 368 ITTOIA provides the necessary exemption for non-residents.[27] In short, they are not chargeable if the security is outside the UK. They are theoretically chargeable if the security is in the UK, but see 31.1 (Limit of liability for non-residents). The company DDS income is within the scope of the TAA provisions. There is no group relief so an inter-group transfer may give rise to a charge.

26.12 Interaction with CGT

A DDS may be a qualifying corporate bond and so outside the scope of CGT.

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26 See 26.4 (Meaning of "profit").

27 See 11.14 (Why does location of source matter?).

CHAPTER TWENTY SEVEN

OFFSHORE UNIT TRUSTS

27.1 Definition(s) of "unit trust"

The High Court of Australia rightly say:

> "unit trust" ... in the absence of an applicable statutory meaning, does not have a constant, fixed, normative meaning ... [1]

However for most tax contexts there is a statutory definition. Section 1007 ITA provides:

> **1007 Meaning of "unit trust scheme"**
> (1) In the Income Tax Acts "unit trust scheme" has the meaning given by section 237 of FISMA 2000.
> This is subject to subsection (2).
> (2) The Treasury may by regulations provide that a unit trust scheme within the meaning given by section 237 of FISMA 2000 is not to be a unit trust scheme for the purposes of this section if the scheme is within a specified description...

CGT is effectively the same. Section 99 TCGA 1992 provides:

> (2) Subject to subsection (3) and section 99A below, in this Act—
> (a) "unit trust scheme" has the meaning given by section 237(1) of the Financial Services and Markets Act 2000
> ...
> (3) The Treasury may by regulations provide that any scheme of a description specified in the regulations shall be treated as not being a

1 *CPT Custodian Pty Ltd v State Revenue* (2005) 221 ALR 196 at [15] accessible *www.austlii.org*.

unit trust scheme for the purposes of this Act; and regulations under this section may contain such supplementary and transitional provisions as appear to the Treasury to be necessary or expedient.

So we turn to s.237 FISMA, which is pleasingly short:

(1) In this Part "unit trust scheme" means a collective investment scheme under which the property is held on trust for the participants.

The definition of "collective investment scheme" is discussed at 23.3 ("Collective investment scheme"). A wide variety of arrangements may be unit trusts.

27.2 Income accruing to unit trust

27.2.1*Authorised unit trusts*

Section 468(1) ICTA provides:

In respect of income arising to the trustees of an authorised unit trust, and for the purposes of the provisions relating to relief for capital expenditure, the Tax Acts shall have effect as if—
(a) the trustees were a company resident in the UK; and
(b) the rights of the unit holders were shares in the company.

So authorised unit trusts are not transparent for IT purposes.
ITTOIA EN Vol II discusses the situs of AUT income:

51. It is possible for the FSA to recognise a non-UK unit trust scheme for marketing into the UK. However, only those UK tax resident unit trusts that are "authorised" by the FSA come within section 468 of ICTA. Section 468(1) of ICTA provides that the Tax Acts apply to UK authorised unit trusts and shall have effect as if the trustees of the authorised unit trust were a company resident in the UK. Although the application of section 468(1) of ICTA is by reference to the trustees' income (and relief for capital expenditure), the treatment of the trustees as a UK resident company carries through for the purposes of taxing interest distributions treated as made to unit holders. That is because section 468L(2) of ICTA provides that the Tax Acts shall have effect as if such interest distributions were made "by the company referred to in section 468(1)". As these distributions are treated as made by such a

company, that is a UK resident company, they can only be UK source income.

The taxation of AUTs is not discussed here.

27.2.2 *Unauthorised unit trust: UK trustees*

Section 504 ITA provides:

> **504 Treatment of income of unauthorised unit trust**
> (1) This section applies for income tax purposes in relation to an unauthorised unit trust if the trustees are UK resident.
> (2) If income arises to the trustees, the income is treated as the income of the trustees and not of the unit holders.
> ...
> (5) Sections 494 and 495 do not apply in relation to payments made by the trustees.

So unauthorised unit trusts with UK resident trustees are not transparent for IT purposes. The taxation of these unit trusts is not discussed here.

27.2.3 *Unauthorised unit trust: foreign trustees*

This leaves the question of unauthorised unit trusts with non-resident trustees. There is no statutory provision so we are thrown back to first principles. It is suggested that ordinary interest in possession trust rules apply. Depending on the drafting and proper law, a unit trust may be a transparent, *Baker* style trust or non-transparent.[2] HMRC agree. The Life Assurance Manual provides:

> **4C.312. Tax Transparency for Income but Not Gains**
> An offshore unit trust will not usually be an authorised unit trust (because of the requirements of section 243(5) FISMA 2000). Nor does section 469 ICTA (LAM 4C.302 above) apply to it. So ordinary trust rules apply and if it is of the transparent type (analogous to a "Baker"

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2 See 11.15 (Income from interest in possession type trusts: identifying the source). This view is supported by *Minister of National Revenue v Trans-Canada Investment Corporation* [1956] SCC 49 accessible *www.kessler.co.uk*, where the Canadian Supreme Court applied *Baker* to a unit trust arrangement.

> trust), a life company is chargeable on its share of the trust income as it arises. This transparency does not apply to capital gains because of section 99(1) TCGA 1992 (which treats all unit trust schemes as companies and hence opaque). ...[3]

A standard unit trust form provides:

> On each Distribution Date the Trustee shall calculate and distribute among the Holders rateably in accordance with the number of Units held or deemed to be held by them respectively on the Distribution Date such amount as shall in the opinion of the Trustee represent the amount of income available for distribution and accordingly such income shall not form part of the Trust Fund. No amount payable to the Holder in respect of any distribution or redemption shall bear interest. Upon the expiry of the period of ten years after any such amount first becomes payable the Holder and any person claiming through, under or in trust for him shall forfeit any right thereto, and such amount shall be retained as part of the Trust Fund or otherwise dealt with in accordance with the provisions of this Instrument.

It is suggested that this creates a *Garland*-style trust even in a *Baker* jurisdiction.

Inspectors Manual para 1617 provided:

> **Foreign investment organisations: Unit trust** Published: 9/95
> Many unit trusts are established outside the UK (for example, in the Channel Islands, Isle of Man, West Indies and Australia) under arrangements identical with or similar to those operating in the UK. All such foreign unit trusts are unauthorised unit trusts (see IM4176) and are, therefore, outside the scope of Section 468 ICTA (see CT3930 onwards), but are unit trust schemes for the purposes of CGT (see TCGA, s 99(1), and CG41300 onwards).
> Normally, a UK resident shareholder in a foreign unit trust is assessable under Case V by reference to his share of the income of the fund[4] whether [1] this is paid out to him in cash or [2] used to purchase additional units.

3 The same point is made at 4C.401.

4 This assumes the unit trust is a non-transparent *Garland*-style trust; or else that it holds only foreign investments.

Point [2] is correct if the income is applied voluntarily by the shareholder to purchase additional units. In other cases it is doubtful. HMRC recognise this in Offshore Funds Guide para 1070:

> **Reinvestment Mechanics** [November 2005]
> In order to meet the distribution test a fund will normally have to have "paid" a distribution which must be in a form that, to the extent that it does not form the profits of a trade, profession or vocation, would be chargeable, in the case of an individual resident in the UK, to Income Tax under a provision specified in Section 830(2) of ITTOIA 2005 or, in the case of a company resident in the UK, chargeable to Corporation Tax under Case III or Case V of Schedule D in accordance with Section 18 ICTA 1988.. A fund with automatic reinvestment of "accumulation" shares may not be able to meet this criterion as there may be doubt about whether it has "paid" a distribution that is capable of being construed as income for UK tax purposes.
> Where such a fund nevertheless wishes to benefit from having distributing fund status it can reach agreement with HMRC that it will apply "reinvestment mechanics". The important point here is that the mechanics of reinvestment establish in principle the chargeability to UK tax of the distribution.
> We take the view that, it would satisfy "paid" for the purposes of the test, provided the distribution
> - passes out of the fund's control and
> - into the hands of a third party, who can **clearly be seen** to receive the distribution and
> - to reinvest it in further shares/units or increase in capital value of the existing shares/units on behalf of the relevant participator.
>
> This does require a physical separation of the distribution from the fund and its subsequent reinvestment, not just a paper transaction.
> (Emphasis original)

Everything depends on the documentation concerned.

27.2.4 *Residence of trustees of unit trust*

The residence of the trustees of a unit trust is important for IT purposes, because the rules set out above depend on whether or not the trustees are UK resident. However, there is no definition of residence for this purpose.

The common IT/CGT definition of residence of "trustees of a settlement"[5] does not apply, because a unit trust is not a "settlement".[6] Ordinary rules of residence apply to determine the residence of the trustees in their private capacities.

27.3 Gains accruing to unit trust

Section 99(1) TCGA provides:

> (1) This Act shall apply in relation to any unit trust scheme as if—
> (a) the scheme were a company,
> (b) the rights of the unit holders were shares in the company, and
> (c) in the case of an authorised unit trust, the company were resident and ordinarily resident in the UK,
> except that nothing in this section shall be taken to bring a unit trust scheme within the charge to corporation tax on chargeable gains.

Thus a UK resident unit trust is subject to CGT, but a non resident one is not (unless carrying a trade in the UK through a branch or agency). The residence of a unit trust is important for CGT purposes. Statute states that authorised unit trusts are UK resident but does not define the test of residence for unauthorised unit trusts. Since a unit trust is treated as a company, it is considered that the test of residence for CGT is the corporate test, i.e., central management and control.

Gains accruing to a non-resident close unit trust fall in principle within the scope of s.13 TCGA, and may be attributed to UK resident unit holders.[7]

27.4 Situs of unit

27.4.1 *Situs for IHT*

The situs of a unit in an authorised unit trust is not normally relevant for

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5 See 4.1 (Residence of trustees).

6 The term "settlement" in this context is not expressly defined, but property in a unit trust is not "settled property" for the purposes of IT: s.466 ITA. It is considered that "settlement", in this context, requires settled property (as defined).

7 Julian Ghosh QC agrees: "When is a company not a company?" PTPR Vol 7 p. 241.

IHT.[8] The situs of a unit in an unauthorised unit trust is important for IHT.

A unit is quite unlike an equitable interest under a conventional trust. The rights of a unit holder arise from contract as well as trust, and a unit is in many ways analogous to a share in a company.[9] One should not apply rules governing other kinds of equitable interests without considering this.

It is considered that share/security situs rules should normally be applied, so that the place of the register is normally the determining factor. HMRC accept this.[10]

Another possible view is that situs depends on the residence of the trustees. In practice a situation where the place of residence of the trustees is different from the place of the register would be rare so the priority between the two tests may never need to be decided. Trustee residence determines whether a unit trust is treated as a company or offshore fund for IT and CGT purposes.[11] It might therefore be said to be consistent with the tax legislation if situs of a unit for IHT depends upon the residence of the trustees. However, situs for IHT is not a tax concept but a general law one, so the relevance of the unit trust tax provisions is very marginal.

What is reasonably clear is that situs of the unit does not depend on the situs of the underlying assets of the unit trust. The idea that one looks at the underlying assets, at first sight seems sensible, as it is consistent with the traditional test for situs of a bare trust. But it is unsound for two reasons:

(1) If the underlying assets are spread across different jurisdictions it would be impossible to ascertain the situs of the unit (if a unit is regarded as a single asset). The unit should not be regarded as several

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8 See 44.3 (Non-settled property authorised unit trusts and OEICs).

9 Thomas & Hudson, *The Law of Trusts*, 1st ed., 2004, paras 51.26–28, says that the rights are *primarily* contractual, but to classify overlapping rights as "primary" and "secondary" seems to me somewhat arbitrary.

10 Press Release 16 October 2002 (OEICs and AUTs) para 9 stated (before the introduction of IHT relief for AUTs):

> "[OEICs and units in Authorised Unit Trusts] are treated as situated in the UK in the same way as other UK registered shares. That is so even if the 'underlying' assets of the collective investment fund are non-UK assets."

See too [1998] PCB 172. This conclusion is supported by *CPT Custodian Pty Ltd v Commissioners of State Revenue* (2005) 2 ALR 196 accessible *www.austlii.org* (unit trust holders not joint "owner" of land for purposes of Australian rating laws).

11 See 23.2 (Meaning of "offshore fund") and 27.2.2 (Unauthorised unit trusts: UK trustees).

separate interests in as many assets as are held by the unit trust, looking through the unit trust like a bare trust, as this is to ignore the nature of the unit.[12]

(2) The proposal to look to the situs of the underlying assets is unworkable because the unit holder will not normally be able to ascertain what the underlying assets are at any particular moment. (Accounts of the unit trust may disclose the position at the end of an accounting period but that will not help as assets are normally bought and sold constantly by the trustees of the unit trust. The unit holder normally has no further right to information.)

Although the consequence is that one can alter situs by interposition of a unit trust, that is not so surprising: one can do the same with an OEIC.

27.4.2 *Situs of unit for CGT*

If the unit trust is governed by a foreign proper law, registered units are situate where they are registered, because that is the rule for shares[13] and the unit is deemed to be a share. This is the same as the common law (and IHT) situs rule for units in a unit trust.

If the unit trust is governed by a UK proper law, a unit is probably UK situate under the UK law rule,[14] or under CGT situs rules for shares in UK incorporated companies.[15] However, a UK law unit trust in practice will have a register here, so the question of priority between the place-of-register rule and the UK law rule will not arise.

The situs of the underlying assets is not relevant. Section 99 clearly overrides s.60 TCGA. A unit is an asset for CGT purposes, rather than an interest in an asset, so that the co-ownership rule is not relevant.[16]

12 A similar argument applies in relation to the situs of an equitable interest under a substantive trust.

13 See 60.4 (Registered shares/debentures: non-UK company).

14 See 60.11.2 (The UK law rule).

15 See 60.3 (Shares/debentures: UK incorporated company). This assumes that a unit trust with a UK proper law should be regarded for CGT as a company incorporated in the UK. That seems the better view, though the contrary is arguable.

16 See 60.13 (Co-ownership).

27.4.3 *Residence of trustees and situs*

The residence of the trustees is not relevant for situs, though non-resident trustees are required if it is desired that the units are not to be chargeable securities for SDRT purposes.[17]

27.5 Gain accruing on disposal of unit

An offshore unit trust will be an offshore fund. It may qualify as a distributing fund, and if so it is not a "non-qualifying fund".[18] If it does not, a gain accruing on a disposal of a unit will be an offshore income gain.

17 See s.99(5A) FA 1986.

18 See 23.1 (Offshore funds).

CHAPTER TWENTY EIGHT

PARTNERSHIPS

28.1 Partnerships - Introduction

This chapter considers aspects of partnerships which are relevant to the theme of this book. For IHT situs issues, see 59.27 (Situs of partnership share). For POA issues see 55.22 (Partnerships).

28.2 "Firm" and "trade"

28.2.1 *Trade*

Before discussing "firm" we need to consider ITTOIA's idiosyncratic definitions of "trade". Section 847 ITTOIA provides:

> (2) The provisions of this Part are expressed to apply to trades but unless otherwise indicated (whether expressly or by implication) also apply—
> (a) to professions, and
> (b) in the case of this section and sections 849, 850, 857 and 858 to businesses that are not trades or professions.
> (3) In those sections as applied by subsection (2)(b)—
> (a) references to a trade are references to a business, and
> (b) references to the profits of a trade are references to the income arising from a business.

Thus the word "trade" always includes profession (it would be appropriate to simplify the law by abolishing all distinctions between professions and trades). The word trade sometimes includes "business". Since it is not convenient to use the same word in two different senses, when trade is used in the wider sense, I refer to it as "**trade (including business)**".

28.2.2 *Firm*

We can now turn to the definition of "firm". Section 847(1) ITTOIA provides:

> In this Act persons carrying on a trade [including business] in partnership are referred to collectively as a "firm".

This is the same as the definition of "firm" in the Partnership Act 1890.[1] "Partnership" is not defined so it has its general (partnership law) meaning.

28.3 Transparency of partnership for IT

After a (somewhat unnecessary) overview in accordance with the principles of Plain English Drafting,[2] s. 848 ITTOIA provides:

> **848 Assessment of partnerships**
> Unless otherwise indicated (whether expressly or by implication), a firm is not to be regarded for income tax purposes as an entity separate and distinct from the partners.

ITTOIA EN provides:

> 1711. This section makes it clear that, for income tax purposes, a firm is not an entity distinct from the partners in the firm. It is based on section 111(1) of ICTA.
> 1712. In the case of firms established under English law this provision merely confirms their position under that law. But Scottish firms, for example, are legal entities. This provision ensures that all firms are treated in the same way.

Partnerships are therefore transparent for IT i.e. partnership income is

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1 The Partnership Act 1890 provides:
> "1(1) Partnership is the relation which subsists between persons carrying on a business in common with a view of profit. ...
> 4(1) Persons who have entered into partnership with one another are for the purposes of this Act called collectively a firm ..."

2 Section 846 ITTOIA provides: "This Part contains some special rules about partnerships."

regarded as income of the partners and not of the partnership as such. But it is suggested that IT transparency follows from basic principles, not from this statutory provision. The Law Commission Report on Partnership Law provides:[3]

> The Inland Revenue justify their approach to UK partnerships[4] by reference to the following three characteristics:
> (1) the partners carry on the business of the partnership with a view to profit;
> (2) every partner is liable jointly or jointly and severally with the other partners for all the debts and obligations of the partnership; and
> (3) the partners own the business, each having at least an indirect share in the net assets of the partnership.[5]

28.4 Partnership income: remittance basis

Section 857 ITTOIA provides:

> **857 Partners to whom the remittance basis applies**
> (1) This section applies if—
> (a) a firm carries on a trade [including business] wholly or partly outside the UK,[6]
> (b) the control and management of the trade [including business] is outside the UK, and
> (c) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to a partner for a tax year.
> (2) The partner's share of the profits of the trade [including business] arising in the UK is determined in accordance with sections 849 to 856.
> (3) The partner's share of the profits of the trade [including business]

3 Law Com 283 (2003) para 4.18.

4 [Footnote in original] This covers both the English law partnership and the Scots law partnership notwithstanding that the former has no separate legal personality and the latter has separate legal personality.

5 [Footnote in original] See *Memec plc v IRC* (1998) 71 TC 77 and in particular Peter Gibson LJ at pp. 111-113. Neither the separate personality of the Scottish partnership nor the absence of mutual agency in Scots law prevented the conclusion that in substance the position of the partners in a Scottish partnership in relation to the profits was the same as in an English partnership (p. 113B–C).

6 Section 857(1)(a) appears to be otiose because if the condition in s.857(1)(b) is met the condition in s.857(1)(a) must be met. But it does not matter.

arising outside the UK is treated as relevant foreign income.

The significance of s.857(3) – treating the income as RFI – is that the income can qualify for the remittance basis.

If the trade is carried on partly in the UK, there is an apportionment to determine the profits arising in/outside the UK.[7]

28.4.1 *Control and management*

Normally a foreign domiciled partner will want to argue that his partnership is controlled abroad, to qualify for the remittance basis, and HMRC will want to argue that control is here. However, if the partnership makes losses the boot may be on the other foot, and the UK partners will argue for residence here, to obtain more generous loss relief.

The expression "control and management" is of course from the company residence test, and it is considered that it should be given the same meaning here. Thus the company residence case law gives guidance.[8] ITH provides at para 1612:

> Generally speaking we follow the thinking on companies and look at the place of the highest level of management rather than day-to-day management. Outside textbooks follow the same line.
> In deciding the location of the control and management of a firm with both UK and overseas partners, we would usually regard as significant such factors as the comparative seniority of the partners in age and experience (a simple head count will not do of course), the extent of their interests in the firm, the source and control of the finance, the places of decision on policy and major transactions, the places and locations of partners' meetings and what was done at those meetings. The place of meetings incidentally is not a conclusive factor any more than it is – or ought to be – for companies. So the nature of the business done at the meeting is important. Is it really about control and management or just part of a facade to mislead us about the place of actual control and management?

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7 See 14.17 (Trade partly in UK: apportionment).

8 There is a discussion in the ITH at para 1614 as to whether "control and management" are two distinct tests with distinct meanings, or a composite phrase. If my approach is right, the words are a single composite phrase.
For a discussion of corporate residence, see 3.35 (Residence of companies).

The ITH continues with another interesting point at para 1613:

> [Section 857 ITTOIA] refers simply to control and management being abroad and the view which we have, in general, adopted in determining whether the Section applies is that this means control etc must be wholly abroad. The strength of this view has never been tested in the Courts and the word 'wholly' does not appear in the Act. It is sometimes put to us that where control and management is partly abroad then [section 857] applies. On the other hand, we have argued that because the Section says 'is situated abroad' it means just that and if control is partly here then it is not abroad.

The Commissioners would normally adopt a broad approach, looking at the whole picture in order to identify one overall place of control where possible, and situations where control was located in the UK and abroad would be rare. If it did arise, the HMRC view seems sound.

28.4.2 *HMRC practice*

The ITH provides:

> **1622. Normal professional partnership: foreign partnership treatment**
> In the Frost case[9] we tried to argue before the Commissioners that control and management was not abroad. That is our approach to any case where partnerships appear to have been set up for the purpose of avoidance and Case V is of advantage, which, as ITH1630 indicates, it may yet be though to a much lesser extent than in earlier years.
> **1623. Foreign partnership treatment: artificial arrangements**
> But a common situation in professions such as engineers and accountants is one where there is a UK partnership and a separate partnership formed abroad with one or more non-UK resident partners in which some or all of the UK partnership partners are members. Generally speaking where the non-resident partners are professionally qualified and the overseas partnership takes on work which is reasonably local to the place where the partnership is based, it is possible to take a fairly relaxed view and accept a claim to Section [857] treatment. That was so even when Case V was on the remittance basis. If, however, the prima facie evidence against this view were very strong, we would look

9 *Newstead v Frost* 53 TC 525.

much more closely.

It seems obvious that in these cases there will be some control in the UK – although proving that that is so is a different matter – but usually the UK resident partners will make visits to the overseas office and there is a case for saying that the management of the partnership is abroad. (This harks back to the Solicitor's Opinion considered in ITH1614.) It may be that some of the overseas partnership work is done in the UK by the UK partnership but this normally happens – or is said to happen – through the UK partnership acting as subcontractor for the overseas partnership.

1624. Foreign partnership treatment: income that of partnership?

If, however, one reaches the position that the ultimate control is in the UK and the bulk of the work is actually done here – albeit under subcontract – then that would be a case for a possible challenge. Cases have been seen where the arrangements were plainly offensive and amounted to no more than attempts to park UK-earned profits in a Section [857] partnership with the admitted intention of avoiding UK tax.

We would certainly want to attack these devices and argue, for example, that the work done in the UK by partners who were also members of the overseas firm was done in their capacity as members of that overseas firm. We could then establish that the profits from those activities could be assessed under Case II. Our Solicitor, on particular cases, has not been discouraging about the chances that we may succeed and in the days of the remittance basis there was some success in settling cases on Case II lines rather than Case V. However, these cases turn crucially on questions of fact and degree and there is the usual difficulty of obtaining information.

1625. Foreign partnership treatment: income that of partnership?

Sometimes we have had to consider whether there is in fact an overseas partnership and/or whether amounts claimed to be receipts of an overseas partnership are in fact receipts of the UK partnership which is seeking to avoid tax. We have had some success with the latter line under circumstances which gave grounds for quiet satisfaction. A firm of UK solicitors which had profited from its fees for advice about the setting up of a well-known tax avoidance scheme, sought to avoid tax on those fees by arranging to park them in a Channel Islands finance and brokerage partnership to which Section [857] was said to apply. This was insult added to injury with vengeance.

Our Solicitor's advice was that we could not challenge the view that control and management was abroad. However, there was considerable artificiality in the arrangements which led ultimately to the fees landing in the accounts of the Jersey partnership. We argued that the amounts were in fact receipts of the UK solicitor's practice and we were aided in this by the fact that it was probably improper for a UK solicitor to enter into a partnership with a non-solicitor to do what they claimed to do in Jersey. This line was eventually conceded and we got tax on the Channel Island profits accruing to the UK partners.

28.5 DTT relief for partnership

Section 858 ITTOIA disapplies DTT relief on partnership income of UK residents. Section 858(1) provides:

> (1) This section applies if—
> (a) a UK resident ("the partner") is a member of a firm which—
> (i) resides outside the UK, or
> (ii) carries on a trade [including business] the control and management of which is outside the UK, and
> (b) by virtue of any arrangements having effect under section 788 of ICTA ("the arrangements") any of the income of the firm is relieved from income tax in the UK.

This survived an attack in *Padmore v IRC (No. 2)* [2001] STC 280. ITTOIA EN provides:

> 1777. For UK tax purposes, if it is necessary to consider where a firm is resident, the question is likely to be decided by the place where the firm's business is controlled and managed. But it is possible that, under foreign law, a firm may be considered to be resident elsewhere, for example, by reference to where the firm was established. So the section uses both the "control and management" test and the "resides" test.

Section 858(2) ITTOIA provides:

> The partner is liable to income tax on the partner's share of the income of the firm despite the arrangements.

ITTOIA EN provides:

> 1774. This section ensures that a UK resident partner's share of the income of a foreign firm remains liable to UK tax even though the income of the firm as a whole is exempt from UK tax in accordance with a double taxation agreement. It is based on section 112(4) and (5) of

ICTA.
1775. The business profits article of the UK/Jersey double taxation arrangement exempts the profits of a Jersey firm from UK tax. In the case of Padmore v IRC 62 TC 352, the Court of Appeal decided that the exemption extended to the share of the profits arising to a UK resident individual. The rules in section 112(4) and (5) of ICTA were enacted in 1987 to remove the exemption.
1776. Subsection (1) sets out the type of individual and firm with which the section is concerned. It goes on to identify the sort of exemption from tax that was considered in the Padmore case. ...
1778. Subsection (2) makes it clear that the section does no more than remove any exemption under a double taxation arrangement. It does not deny other reliefs, such as tax credit relief. See Change 145 in Annex 1.[10]

Section 858(3) ITTOIA provides:

> If the partner's share of the income of the firm consists of or includes a share in a qualifying distribution—
> (a) made by a UK resident company, and
> (b) chargeable to tax under Chapter 3 of Part 4,
> the partner (and not the firm) is, despite the arrangements, entitled to the share of the tax credit which corresponds to the partner's share of the distribution.

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10 Change 145 is as follows:
This change enacts the Inland Revenue practice of giving a narrow interpretation to the word "affect" in section 112(4) of ICTA.
The business profits article of the UK/Jersey double taxation agreement exempts the profits of a Jersey firm from UK tax. In the case of *Padmore v IRC* 62 TC 352 the Court of Appeal decided that the exemption covered the share of the profits arising to a UK resident partner. The rules in section 112(4) and (5) of ICTA were enacted in 1987 to remove the exemption.
It was intended, in the case of income tax, that the 1987 legislation should do no more than remove the exemption claimed in the *Padmore* case. The words used in section 112(4) of ICTA are "shall not affect any liability to tax". On the face of it, these words could deny the partner any relief, including tax credit relief, under a double taxation treaty. Section 858(2) of this Act makes it clear that it is only the partner's chargeability to tax that is preserved, overriding any provision to the contrary in a double taxation treaty. No other effect of the treaty is overridden.
This change is in principle in taxpayers' favour but is expected to have no practical effect as it is in line with current practice.

ITTOIA EN provides:

> 1779. Subsection (3) deals with UK tax credits. A double taxation arrangement may give a non-resident person an entitlement to payment of a tax credit on a distribution by a UK company. The entitlement is restricted to the share of the distribution that arises to a UK resident partner.

28.5.1 *"Members of a firm"*

Section 858(4) defines "members of a firm":

> For the purposes of this section, the members of a firm include any person entitled to a share of income of the firm.

Section 58(4) FA 2008 provides:

> The amendments made by subsections (1) to (3) are treated as always having had effect.

Retrospective legislation without limit of time! The EN to the draft clause published 12 March 2008 provides a somewhat untechnical explanation of the scheme, which involved trustees of 2 IP trusts trading in partnership.[11]

> 11. The users of the scheme claim that, under the terms of the relevant Double Taxation Treaty, the UK is not entitled to tax the partnership income of the foreign trustees. As that income is precisely the same income as that received by the UK individuals as beneficiaries of the trust, they argue that the UK is not entitled to tax the UK individuals on it.

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11 "8. An avoidance scheme purports to exempt from UK tax income received by UK resident individuals by using certain provisions in the UK's bilateral Double Taxation Treaties.
9. This scheme involves the establishment of offshore trusts, (of which the UK individuals are both settlors and beneficiaries) and partnerships (of which the foreign trustees of those trusts are partners).
10. The partnerships acquire the rights to receive the UK individuals' income but the terms of the trusts are such that, as beneficiaries of the trust, the UK individuals retain beneficial entitlement to the income – with the trustees obliged to remit the income to the UK individuals as it arises."

> 12. Legislation was introduced in Finance (No 2) Act 1987, which provided that (as had almost universally been assumed to be the case until a High Court decision to the contrary,) a Double Taxation Treaty did not affect UK residents' liability to UK tax on their share of income or gains from a foreign partnership.
> This new avoidance scheme purports to get round that legislation by claiming that the foreign trustees are the partners rather than the UK individuals.
> 13. The Government believes that a partner for the purposes of that legislation has always included all those persons entitled to a share of income or capital gains of the partnership. As such, the UK individuals remain liable to UK tax despite the elaborate, artificial structure designed to exempt them. This clause will put it beyond doubt that the legislation has always had that effect.

This justification of the retrospective nature of the 2008 amendment raises questions of law, fact, policy, practice and human rights.

As a matter of law, was it the case (before the retrospective legislation) that "partner" for the purposes of that legislation has always included all those persons entitled to a share of income or capital gains of the partnership? The answer is, no.[12]

As a matter of fact, did the Government believe that to be the case? I think it is a safe bet that if HMRC received expert and impartial advice on the point, it would have been hedged with caveats such that the terms of EN para 13 would not represent a fair and accurate summary of the position.[13]

The question of policy is whether the reasons given justify retrospective legislation.[14] One might discern two reasons from the EN. The first is that the scheme will fail (or so the Government believe). If that is true, the

12 Partner is a term of partnership law, and in the partnership law sense a person who is entitled to income or gains of a partnership is not as such a partner. HMRC would have to argue that "partner" in s.858 was not used in its partnership law sense, which is a difficult line to take even in these times of purposive interpretation, though in a tax avoidance case nothing is impossible.

13 In Parliament the statement was described as "disingenuous": Public Bill Cttee debate on Finance Bill, 22 May 2008 Hansard col 371.

14 For an illuminating discussion of the policy issues in a US context, see "When Rules Change", Daniel Shaviro, 2000, University of Chicago Press. Taxpayers may on this point look with envy to the USA, where a norm opposing retrospective legislation is "strongly rooted in popular sentiment, legislative practice, and perhaps even the Constitution as the Courts are likely to interpret it" (p.104).

2008 change is unnecessary; if false (and it is certainly debatable) it is not a good reason. The only reason worth considering is that the scheme is "elaborate and artificial", or, HMRC might fairly have said, abusive (however that flexible term may be defined). Whether that justifies retrospective legislation is ultimately a political question on which views differ depending on how one values the rule of law. It is arbitrary and unfair in that this scheme was retrospectively stopped and others – no less elaborate, artificial and abusive – were not. Pragmatists (to whom constitutional proprieties such as the rule of law are of little interest) should bear in mind that retrospective legislation increases the "legal risk", a measure under which the UK falls low on international surveys, and the lowering of the UK's reputation in that regard has a significant albeit intangible cost. I suspect a major factor in picking on this arrangement, though not mentioned in the EN, was the amount of money involved.

The question of practice is how often retrospective legislation will be used in the future. What advice can anyone give to clients seeking to know their position? The answer of course is that one cannot give a clear answer. Much depends on the politics of the day as they develop, but I guess that retrospective legislation will continue to be a rare response; a scheme which everyone is doing is certainly more at risk than others.

Lastly, does the retrospective legislation breach the Human Rights Act? An application has been made to the European Court, but it will take years before a final decision is reached on this point.

28.5.2 *DTT for partnership gains*

Section 59 TCGA sets out the same rules for CGT:

> (2) Subsection (3) applies if—
>
> (a) a person resident in the UK ("the resident partner") is a member of a partnership which resides outside the UK or which carries on any trade, profession or business the control and management of which is situated outside the UK, and
>
> (b) by virtue of any arrangements falling within section 788 of the Taxes Act ("the arrangements") any of the capital gains of the partnership are relieved from capital gains tax in the UK.
>
> (3) The arrangements do not affect any liability to capital gains tax in respect of the resident partner's share of any capital gains of the partnership.

(4) For the purposes of subsections (2) and (3) the members of a partnership include any person entitled to a share of capital gains of the partnership

28.6 Residence of partnership

The residence of a partnership is not often important for tax, but it matters occasionally:

(1) The provision relating to the disallowance of partnership DTR refer to a firm which resides outside the UK.[15]
(2) In order to be a foreign employer (and so have chargeable overseas earnings) a partnership must be resident outside the UK and not resident in the UK.[16]
(3) Some DTTs refer to residence of partnerships.[17]

Until 1995 the position was governed by s.112(1) ICTA 1988:

> *Where a trade or business is carried on by two or more persons in partnership, and the control and management of the trade or business is situated abroad, ... the partnership shall be deemed to reside outside the UK ...*

Now there is no statutory definition, but it is considered that the test of partnership residence is still control and management. This is consistent with the general scheme of UK taxation of partnerships. ITTOIA EN agrees, in the passage set out above ("For UK tax purposes, if it is necessary to consider where a firm is resident, the question is likely to be decided by the place where the firm's business is controlled and managed....").

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15 See 929, 930, 931, 935, 1806 (DTT Relief for partnerships).

16 See 12.4 (Foreign employer).

17 For example, Art. 2(1) of the UK/Jersey DTT provides:

> The terms "resident of the UK" and "resident of Jersey" mean respectively any person who is resident in the UK for the purposes of UK tax and not resident in Jersey for the purposes of Jersey tax and any person who is resident in Jersey for the purposes of Jersey tax and not resident in the UK for the purposes of UK tax;

A partnership is a person for this purpose: *Padmore v IRC* 62 TC 352.

28.7 Transparency of partnership for CGT

Section 59(1) TCGA provides:

> Where 2 or more persons carry on a trade or business in partnership—
> (a) tax in respect of chargeable gains accruing to them on the disposal of any partnership assets shall, in Scotland as well as elsewhere in the UK, be assessed and charged on them separately, and
> (b) any partnership dealings shall be treated as dealings by the partners and not by the firm as such.

This somewhat scanty foundation for the CGT treatment of partnerships is expanded by SP D12:

> Disposals of assets by a partnership
> Where an asset is disposed of by a partnership to an outside party each of the partners will be treated as disposing of his fractional share of the asset.

Thus partnerships are transparent for CGT. For CGT one has regard to the situs of the partnership assets, and the situs of the partnership share is irrelevant. The question then is to identify the fractional share of each partner, and that is more tricky as partners do not always have easily identifiable fractional shares. The SP provides:

> In computing gains or losses the proceeds of disposal will be allocated between the partners in the ratio of their share in asset surpluses at the time of disposal. Where this is not specifically laid down the allocation will follow the actual destination of the surplus as shown in the partnership accounts; regard will of course have to be paid to any agreement outside the accounts. If the surplus is not allocated among the partners but, for example, put to a common reserve, regard will be had to the ordinary profit sharing ratio in the absence of a specified asset-surplus-sharing ratio. Expenditure on the acquisition of assets by a partnership will be allocated between the partners in the same way at the time of the acquisition. This allocation may require adjustment, however, if there is a subsequent change in the partnership sharing ratios (see para 4).

"Partnership" is not defined for the TCGA so the word will bear its usual

(Partnership Act) meaning.

28.8 Limited liability partnership

An LLP is (as a matter of LLP law) a body corporate,[18] and so in principle a company for tax purposes. However this default position is subject to such wide exceptions that it hardly ever applies.

28.9 *Income tax*

Section 863 ITTOIA provides:

> (1) For income tax purposes, if a limited liability partnership carries on a trade, profession or business with a view to profit—
> (a) all the activities of the limited liability partnership are treated as carried on in partnership by its members (and not by the limited liability partnership as such),
> (b) anything done by, to or in relation to the limited liability partnership for the purposes of, or in connection with, any of its activities is treated as done by, to or in relation to the members as partners, and
> (c) the property of the limited liability partnership is treated as held by the members as partnership property.
> References in this subsection to the activities of the limited liability partnership are to anything that it does, whether or not in the course of carrying on a trade, profession or business with a view to profit.
> (2) For all purposes, except as otherwise provided, in the Income Tax Acts—
> (a) references to a firm or partnership include a limited liability partnership in relation to which subsection (1) applies,
> (b) references to members or partners of a firm or partnership include members of such a limited liability partnership,
> (c) references to a company do not include such a limited liability partnership, and
> (d) references to members of a company do not include members of such a limited liability partnership.

Thus an LLP is treated like a simple partnership (provided it is carrying on a business with a view to profit). Section 863 then deals with the position

18 Section 1 Limited Liability Partnerships Act 2000.

where the LLP ceases to do that:

> (3) Subsection (1) continues to apply in relation to a limited liability partnership which no longer carries on any trade, profession or business with a view to profit—
> (a) if the cessation is only temporary, or
> (b) during a period of winding up following a permanent cessation, provided—
> (i) the winding up is not for reasons connected in whole or in part with the avoidance of tax, and
> (ii) the period of winding up is not unreasonably prolonged.
> This is subject to subsection (4).
> (4) Subsection (1) ceases to apply in relation to a limited liability partnership—
> (a) on the appointment of a liquidator or (if earlier) the making of a winding-up order by the court, or
> (b) on the occurrence of any event under the law of a territory outside the United Kingdom corresponding to an event specified in paragraph (a).

28.9.1 *CGT*

Section 59A(1) TCGA deals with limited liability partnerships:

> Where a limited liability partnership carries on a trade or business with a view to profit—
> (a) assets held by the limited liability partnership are treated for the purposes of tax in respect of chargeable gains as held by its members as partners, and
> (b) any dealings by the limited liability partnership are treated for those purposes as dealings by its members in partnership (and not by the limited liability partnership as such);
> and tax in respect of chargeable gains accruing to the members of the limited liability partnership on the disposal of any of its assets shall be assessed and charged on them separately.[19]

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19 Section 59A(2) TCGA is the equivalent of s.863(2) ITTOIA:
> (2) For all purposes, except as otherwise provided, in the enactments relating to tax in respect of chargeable gains—
> (a) references to a partnership include a limited liability partnership in relation to which subsection (1) above applies,
> (b) references to members of a partnership include members of such a

This puts an LLP in the same position as a simple partnership. Section 59A(3)–(5) deal with the position where a limited liability partnership ceases to carry on a business with a view to profit, or is wound up; they are equivalent to s.863(3)(4) ITTOIA.

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limited liability partnership,

(c) references to a company do not include such a limited liability partnership, and

(d) references to members of a company do not include members of such a limited liability partnership.

CHAPTER TWENTY NINE

WITHHOLDING TAX ON INTEREST

29.1 Withholding tax – Introduction

This chapter considers when tax must be deducted at source on the payment of interest. This chapter considers:

(1) Payment by individuals, trustees and PRs to non-residents; I refer to this as "**non-resident's withholding**".
(2) Payment of interest by deposit-takers (banks); I refer to this as "**deposit-takers withholding**".
(3) The EU Interest and Savings Directive.

Each topic requires a book to itself, except for the EU directive which requires many volumes.

29.2 Non-resident's withholding

Section 874 ITA provides:

> **874 Duty to deduct from certain payments of yearly interest**
> (1) This section applies if a payment of yearly interest arising in the UK is made—
> (a) by a company,
> (b) by a local authority,
> (c) by or on behalf of a partnership of which a company is a member, or
> (d) by any person to another person whose usual place of abode is outside the UK.
>
> (2) The person by or through whom the payment is made must, on making the payment, deduct from it a sum representing income tax on it at the basic rate in force for the tax year in which it is made.

For interest paid by individuals, trustees and PRs the obligation to withhold arises under s.874(1)(d) when the following conditions are satisfied:

(1) A payment of yearly interest.
(2) The interest arises in the UK.
(3) The payment is made to a person whose "usual place of abode" is outside the UK. In the following discussion a person whose usual place of abode is in the UK is described (for brevity) as "**outside the UK**".

29.2.1 *Failure to deduct*

INT Manual provides:

> **542030. Consequences of failure to deduct withholding tax** [March 2007]
> In the absence of a claim under a double taxation agreement for interest payments to be made gross (or at a reduced rate of withholding tax) the UK borrower is obliged to deduct withholding tax on making payments of annual interest abroad and pay these over to HM Revenue & Customs.
> In the event of a failure to deduct withholding tax the provisions of Schedule 16 ICTA 1988 apply and assessments may be made to recover the tax due.
> Where withholding tax is paid late, late payment interest may be due under the provisions of Section 87 TMA 1970.
> See INTM574040 for further details.

29.3 To whom is interest paid?

Since the duty to withhold arises on a payment to a person who is not in the UK, it is necessary to identify the person to whom the payment is made.[1]

Suppose:

(1) interest is paid to a transparent (*Baker*-style) interest in possession trust which is not a settlor-interested trust; and

1 See 14.2 (To whom does trading income arise?).

(2) the trustees are in the UK but the life tenant is outside the UK.

It is suggested that the interest is paid "to" the trustees (who have a lien). So the person paying the interest to the trustees need not deduct; but the trustees must do so when they pay the interest to the life tenant. But if the trustees mandate the income to the life tenant, the payer has an obligation to deduct.

Suppose:

(1) interest is paid to a settlor-interested trust; and
(2) the trustees are outside the UK and the settlor is in the UK.

At first sight there is no obligation to deduct as the interest is treated as income of the settlor "and of the settlor alone". Following the deeming, the payment should be treated as paid to the settlor. Conversely, if the settlor is outside the UK, there is an obligation to deduct even if the trustees are in the UK. It is suggested that that is the correct view. This is consistent with the position for deposit-takers. But this result is surprising: the payer is expected to know whether the payee is outside the UK, but he cannot be expected to know if the recipient is a settlor-interested trust, and if so, who is the settlor and is he outside the UK.

Section 646(8) ITTOIA provides:

> Nothing in sections 624 to 632 is to be read as excluding a charge to tax on the trustees as persons by whom any income is received.

This is not entirely to the point but it illustrates the view that the deeming of s.624 does not apply in all cases.

Suppose:

(1) interest is paid to a non-resident company within s.720; and
(2) the transferor is in the UK.

The transferor is taxable under s.720 on income treated as arising to him, but the interest is still the income of the company. So there is an obligation to deduct.

29.4 Usual place of abode

29.4.1 *Introduction*

The expression "usual place of abode" occurs in s.42A ICTA (withholding tax on rent) as well as here in the context of withholding tax on interest. The meaning in both cases is the same.[2]

The meaning of the expression is discussed in Property Income Manual and in the SAI Manual. I set out both passages because they make different points.

The PI Manual 4800 provides:

> Meaning of "usual place of abode" [February 2007]
> "Usual place of abode" is not identical in meaning to residence, or ordinary residence, but a person who is not resident in the UK should normally be treated as having their usual place of abode outside the UK. You should interpret the term in accordance with the following guidelines.

Likewise the SAI Manual para 9080:

> **Meaning of "place of abode"**
> Section 874(1)(d) ITA 2007 requires deduction of tax from a payment to a person "whose usual place of abode is outside the UK". This phrase is distinguishable from the concept of "residence", and is to be interpreted as follows.

29.4.2 *Individuals*

The PI Manual provides:

> a. Individuals have a usual place of abode outside the UK if they usually live outside the UK. You should still regard the term as applying to them even if in a particular year they are resident in the UK for tax purposes, as long as the usual place of abode is outside the UK. (For example the individual may count as resident in the UK in a particular

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2 This is supported by ITA EN para 2648: "The term 'usual place of abode' is consciously retained, *because it is a technical term*, distinct from residence" (emphasis added).

year because of a six months' visit, [or a visit of a shorter time when he has a place of abode available in the UK].)[3] Do not treat someone as having their usual place of abode outside the UK if they are only temporarily living outside the UK, say for six months or less.

The SAI Manual makes the same point more tersely:

An individual's usual place of abode is outside the UK if he or she usually lives abroad, unless that arrangement is temporary.

29.4.3 *Companies*

The PI Manual continues:

b. Companies that have their main office or other place of business outside the UK, and companies incorporated outside the UK, will normally have a usual place of abode outside the UK. However if the company is treated as resident in the UK for tax purposes, do not treat it as having a usual place of abode outside the UK.

The SAI Manual addresses the question of UK branches of non-resident companies:

A non-UK resident company that has a UK permanent establishment that is within the charge to corporation tax does not have a usual place of abode abroad.

The HMRC guidance notes on the Non-resident Landlords Scheme likewise provides:

2.5 The UK branch of a non-resident company, where that branch is within the charge to Corporation Tax, does not have a usual place of abode outside the UK for the purposes of the NRL Scheme.[4]

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3 Author's note: This refers to the supposed "available accommodation rule" which was abolished in 1993. The passage was no doubt written before 1993 and has not been updated since.

4 Accessible *www.hmrc.gov.uk/cnr/nrl_guide_notes.pdf*.

This practice seems surprising, but it favours the taxpayer so it will not be challenged.

29.4.4 *Trustees and PRs*

The PI Manual provides:

> c. Trustees have a usual place of abode outside the UK if all the trustees have a usual place of abode outside the UK.

The SAI Manual provides:

> Trustees, including personal representatives, have a usual place of abode abroad if each trustee, considered as an individual or a company as the case may be, has a usual place of abode there. So if one trustee does not have a usual place of abode abroad, neither does the trust.

This text was probably composed before the statutory residence rules for trustees and PRs. One might have thought that the usual place of abode for trustees and PRs is where they are resident under those rules. But the HMRC practice favours the taxpayer so it will not be challenged. It is also satisfactory for HMRC; as long as one trustee is here, HMRC can collect tax from that trustee and do not need the assistance of a withholding tax.

29.4.5 *Miscellaneous*

The HMRC guidance notes on the Non-resident Landlords Scheme makes further comments which are also relevant to deduction of interest:

> **Jointly owned property**
> 2.7 Where a property is jointly owned and one or more of the joint owners has a usual place of abode outside the UK, the share of rental income applicable to those joint owners falls within the NRL Scheme. The share applicable to joint owners who do not have a usual place of abode outside the UK does not fall within the Scheme. For husband and wife joint-ownership cases, see para 2.8 below.
> **Husband and wife joint-ownership cases**
> 2.8 Where a husband and wife jointly own a UK property and both have their usual place of abode outside the UK, the NRL Scheme applies to both spouses and each is treated as a separate landlord in their own

right. If the husband and wife both wish to receive the rental income with no tax deducted they must each complete a separate application form and send it to the Inland Revenue (see Chapter 11 below). In such cases, letting agents and tenants should pay rental income with no tax deducted only to the spouse(s) named on Inland Revenue authorities they hold. Under no circumstances should they pay with no tax deducted to a husband and wife where they hold an authority to do so for only one spouse. But if only one of the spouses has a usual place of abode outside the UK, the NRL Scheme applies only to that spouse's share of the rental income. The rental income belonging to the UK resident spouse is not within the Scheme and no Inland Revenue approval is required to pay the income with no tax deducted.

Members of HM Armed Forces and other Crown Servants

2.9 Members of HM Armed Forces and other Crown Servants, including diplomats, are treated no differently from any other non-resident landlords. So if they receive UK rental income and have a usual place of abode outside the UK (see para 2.3 above) the NRL Scheme applies to them.

2.10 If members of HM Armed Forces and other Crown Servants whose usual place of abode is outside the UK wish to receive rental income with no tax deducted, they should apply to HMIT Public Department 1 or South Wales Area tax office, as appropriate, for approval (see Chapter 11.1 below).

How do letting agents and tenants know whether a landlord has a "usual place of abode" outside the UK?

2.11 A landlord's usual place of abode (see paras 2.3 to 2.6 above) will usually be evident without the need for special enquiries. If it is outside the UK, letting agents or tenants should operate the NRL Scheme. If the usual place of abode is in doubt, letting agents and tenants should get more information from the landlord to satisfy themselves on the point. In particular, PO Box numbers and "care of" addresses alone should *not* be relied on as evidence that the Scheme does not apply. In cases of difficulty letting agents can get advice from the Centre for Non-Residents (see para 1.15 above).

2.12 Where letting agents and tenants have no reason to believe that a landlord has a usual place of abode outside the UK they are not required to make any special enquiries. In these circumstances they do not have to operate the Scheme.[5]

5 Accessible *www.hmrc.gov.uk/cnr/nrl_guide_notes.pdf*.

29.4.6 *Commentary*

Do we need a concept of "place of abode" in addition to a concept of residence? At first sight it seems that the law could and should be simplified by replacing the reference to usual place of abode with a reference to residence. At present we do need a separate concept: a rule requiring deduction of interest at source on payment to a non-resident would be difficult to apply because "residence" is far too unclear. For a payer to ascertain the residence of the lender would require searching enquiries and even then the payer would often not know if the lender was non-resident. The lender himself may not know. To ascertain the "usual place of abode" may be a little more practical. But if we had a proper definition of "residence" then we could and should adopt it here and "place of abode" should be abolished.

29.5 Exceptions to obligation to deduct

Sections 875–888 ITA set out 14 exceptions to the duty to deduct. Those most relevant to this book are as follows.

29.5.1 *Foreign source interest*

Section 884(1) ITA provides:

> The duty to deduct a sum representing income tax under section 874 does not apply to a payment of interest which is chargeable to income tax as relevant foreign income.

This is otiose, as the obligation applies only to interest arising in the UK. The SAI Manual correctly states at para 9090:

> The obligation to deduct tax from interest that has a UK source is imposed by Chapter 3 of Part 15 ITA 2007 (formerly Section 349(2) ICTA 1988). Section 874 ITA 2007 specifies that the interest must be "yearly interest arising in the UK". Section 884 ITA 2007 makes it clear that this excludes "relevant foreign income", that is, income arising outside the UK (see SAIM1130).
>
> So whether or not tax should be deducted from interest paid on an overseas loan depends on the source of the interest. If the interest has a UK source tax must be deducted, if it does not then tax should not be

deducted.

29.5.2 *Interest paid to UK bank*

Section 879(1) ITA provides:

> The duty to deduct a sum representing income tax under section 874 does not apply to a payment of interest on an advance from a bank if, at the time when the payment is made, the person beneficially entitled to the interest is within the charge to corporation tax as respects the interest.[6]

This would apply to a UK branch of a non-resident bank, though it may be that such companies do not have their usual place of abode abroad.

29.5.3 *Short interest*

Tax law distinguishes between:

(1) "yearly" or "annual" interest (the terms are synonymous); and
(2) other interest (known as "short" interest).

The duty to deduct tax does not apply to short interest. The SAI Manual explains the distinction:

> **9075. Yearly interest: Case law on short and yearly interest** [January 2009]
> *When is interest "short" or "yearly"?*
> Although tax law has made a distinction between yearly and short interest since 1806, there is no statutory definition of yearly interest. The distinction rests wholly on case law.
> The classic example of short interest is interest payable on a bank loan for less than a year. In the early case of *Goslings and Sharpe v Blake* (2

6 For completeness, s.879 continues:
"(2) Section 991 (meaning of 'bank') applies for the purposes of this section.
(3) Subsection (1) applies to the European Investment Bank as if the words from 'if' to the end were omitted.
(4) An order under subsection (2)(e) of section 991 designating an international organisation as a bank may provide that subsection (1) applies to the organisation with the modification mentioned in subsection (3)."

TC 450), the Court of Appeal confirmed that interest on such a loan, where there was no provision to extend the borrowing for more than a year, could not be yearly interest, notwithstanding the use of an annual percentage rate.

It is therefore a useful starting point to say that where a loan or debt is for less than a year, there is a presumption that it gives rise to short interest. Conversely, interest on a loan or debt that exists for more than a year is likely to be yearly interest.

But you cannot just apply this as a mechanical rule, with the benefit of hindsight. Particular difficulties may occur where, at the time when a loan or debt comes into existence, it is not clear how long it is going to last.

For example, the case of *Bebb v Bunny* (1854) 1 K&J 216 concerned the payment into court of the purchase price of a property, with interest on the delayed payment. It would have been possible for the interest to have run for more than a year if the purchaser had been particularly late in paying. The judge held that the interest was yearly. On the other hand, the Court of Appeal held, in *Gateshead Corporation v Lumsden* [1914] 2 KB 883, that certain interest which had run for more than a year was nevertheless short interest. The interest in question was statutory interest due to Gateshead Corporation on late-paid contributions towards the cost of making up roads. The court took the view that the mere failure by the Corporation to enforce the debt within a year did not make the interest "yearly interest".

To distinguish interest arising on long-term loans from that arising on apparently short-term debts, the courts began to lay stress on the debt having "a measure of permanence" or being "in the nature of an investment" as opposed to being merely "temporary accommodation". Thus in *Corinthian Securities Ltd v Cato* (46 TC 93) the Court of Appeal decided that interest on a bank loan, repayable on demand, was yearly interest because the loan had the quality of investment – even though, in the event, the loan was called in after 6 months.

However, the leading case on yearly interest is now considered to be *Cairns v MacDiarmid* (56 TC 556). In this case, the Court of Appeal saw the intention of the parties as the determining factor. If the debtor and creditor intend that the debt should subsist for more than a year, or where there is mutual acceptance that the interest may have to be paid from year to year, the interest will be yearly. This principle was applied in *Minsham Properties Ltd v Price* (63 TC 570), where a loan from a parent company, repayable on demand, gave rise to yearly interest because it was regarded by both parties as permanent finance.

It was felt in *Cairns v MacDiarmid* that merely asking whether a loan had the character of an investment was a less useful test – even an overnight deposit of money might be regarded as an "investment".

9076. Practical application [November 2007]

Applying case law principles

It is always a question of fact whether, in any particular case, interest is yearly or short. The intention of the parties will be the most important factor in deciding the question (see SAIM9075).

The question of whether interest is short interest, from which the payer has no obligation to deduct tax, is most likely to arise in the context of payments made by a UK resident to a person whose usual place of abode is outside the UK. If the interest is short, there is no need for the recipient to apply under a relevant Double Taxation Agreement to receive the interest gross (or with tax withheld at a reduced rate). There is guidance at INTM505010 onwards.

A UK resident may make a series of loans, each of less than a year, to a non-resident, and claim that the interest is short. HMRC staff should refer to the guidance at INTM542010 in such cases.

Uncertainty may also arise as to whether there is a duty to deduct tax from interest in circumstances comparable to that in *Bebb v Bunny* (SAIM9075) – where a sum of money remains outstanding for a period that may, or may not, be longer than a year. For example, a manufacturer might guarantee to refund the purchase price, with interest from the date of claim, if a product proves faulty: such claims may normally be processed speedily but, in disputed cases, may drag on for over a year.

Where the parties intend at the outset that monies due will not be left outstanding longer than 12 months, the interest will be short – even if, in a few cases, there are delays which prolong the period over which interest accrues. If however the parties anticipate at the beginning that the debt will exist for more than a year, or appear to be indifferent as to whether it will or not, the interest is likely to be yearly.

Where the payer of the interest is uncertain about whether it is short or yearly, they may in practice "play safe" by deducting tax. If the recipient of such interest objects to the tax deduction, HMRC staff should advise him or her to take up the matter with the payer, see SAIM9180.

If, conversely, the payer decides that interest is short and pays it gross, HMRC staff should not challenge that view unless

- the decision appears to be completely unjustified on the facts and in the light of relevant case law, or there is reason to suspect a definite intention of avoiding the payment of withholding tax; and
- material sums of tax are at risk.

Overdraft interest is usually short interest.

The INT Manual provides:

> **542010. Provisions of Section 349(2) ICTA 1988** [March 2007]
> In some circumstances, an overseas lender may seek to circumvent the provisions of Section 349(2) ICTA 1988 by advancing a series of short-term consecutive loans, each for a period of less than one year. It may then be argued that the interest is not annual interest but short interest, to which the provisions of Section 349(2) ICTA 1988 do not apply. This argument is open to challenge unless the UK borrower can show that there was no need for long term funding or that alternative sources of funding were readily available to replace that which was argued to be short term.
> Where Inspectors meet a situation in which a long-term funding requirement is being met via a series of short-term loans, they should refer for advice to CT & VAT, Business Profits & Relief.

Challenge would be harder if the short-term loans are each from separate lenders.

29.5.4 *Discounts and premiums*

The duty to deduct tax does not apply to:

(1) profits on discounts (which are normally treated as interest but which are expressly taken out of the duty to deduct);
(2) premiums even though premiums may be charged to income tax.

SAI Manual 3070 rightly provides:

> **Deduction of tax**
> Discounts or premiums payable on the redemption of relevant discounted securities[7] are not payments of interest. Consequently the payments are made without deduction of tax.

However, the distinction between interest and premiums can be fraught.

7 Discounts and premiums on securities which are not "relevant discounted securities" are also not "interest".

29.6 Double tax treaty defence

Regulation 2(1) Double Taxation Relief (Taxes on Income) (General) Regulations 1970 provides:

> The following provisions of these Regulations shall have effect where, under arrangements having effect under section 497 ICTA 1970 [now s.788 ICTA], persons resident in the territory with the government of which the arrangements are made are entitled to exemption or partial relief from UK income tax in respect of any income from which deduction of tax is authorised or required by the Income Tax Acts.

This applies where interest qualifies for relief under a DTT. Regulation 2(2) provides the exemption from withholding tax:

> Any person who pays any such income (referred to in these Regulations as "the UK payer") to a person in the said territory who is beneficially entitled to the income (such person being referred to in these Regulations as "the non-resident") may be directed by a notice in writing given by or on behalf of the Board that in paying any such income specified in the notice to the non-resident he shall—
>
> (a) not deduct tax, or
>
> (b) not deduct tax at a higher rate than is specified in the notice, or
>
> (c) deduct tax at a rate specified in the notice instead of at the lower or basic rate otherwise appropriate;
>
> and where such notice is given, any income to which the notice refers, being income for a year for which the arrangements have effect, which the UK payer pays after the date of the notice to the non-resident named therein shall, subject to the following provisions of these regulations, be paid as directed in the notice...

29.6.1 *Which treaties provide relief?*

The question whether interest qualifies for exemption depends of course on the DTT concerned. The OECD Model Convention does not provide exemption but only a partial relief. Countries whose DTTs provide complete exemption include Ireland, Luxembourg, Switzerland and USA.[8]

The Jersey, Guernsey and Isle of Man DTTs do not provide an exemption for interest. They do however provide exemption for business profits. Art 3(2) Jersey DTT is typical:

> The industrial or commercial profits of a Jersey enterprise shall not be subject to UK tax unless the enterprise is engaged in trade or business in the UK through a permanent establishment situated therein. If it is so engaged, tax may be imposed on those profits by the UK, but only on so much of them as is attributable to that permanent establishment.

This confers relief provided:

(1) The recipient is a Jersey enterprise as defined (e.g. a Jersey bank).
(2) The recipient is not engaged in trade or business in the UK through a permanent establishment situated here (or if it is so engaged, the interest does not relate to that PE's profits).

The exemption for business profits exempts the interest even though the interest is a component part of the profits. HMRC agree. Para 355225 International Manual provides:

> **355225. Industrial or commercial profits paragraph** [July 2005]
> Para 3 provides for the relief from UK tax of "the industrial or commercial profits of a Jersey enterprise".
> In practical terms, this means that we can allow relief on UK interest paid to a bona fide bank in Jersey, since it can be held that interest represents part of the bank's profits as defined by para 3.
> So if you get a claim from a bank in Jersey you will need to;
> - be certain that it is a recognised bank – the Banker's Almanac will help you here
> - consider if you should have the loan agreement reviewed by the inspector of taxes who deals with the accounts of the UK borrower – the guidance at INTM342010 will help you here
>
> If these checks are satisfactory, you can allow **full** relief.
> **But** if you receive a claim from a Jersey enterprise in respect of any other category of income, please refer to Technical Advice Group before

8 UK/Ireland DTT Art.12. UK/Luxembourg DTT Art.11. UK/Switzerland DTT Art.11; UK/USA DTT Art. 11.

taking any action.[9]

29.6.2 *Procedure for claiming relief*

For the procedure see RI 79, Tax Bulletin 41, and the HMRC booklet "Double Taxation Relief Provisional Treaty Relief Scheme".

The application forms are available online.[10]

HMRC Residency Double Taxation Guidance Note 1 deals with applications for relief at source on interest payments where both lender and borrower are outside the UK:

> This Guidance Note explains how HM Revenue & Customs (HMRC) Residency Nottingham handles applications for relief at source from UK income tax under a double taxation treaty in respect of interest payments where both lender and borrower are outside the UK.
> [After some general comments on the law the note continues]
> In its consideration of an application for relief at source in such circumstances, HMRC Residency must be satisfied that all the elements necessary to give relief are present. In the circumstance where the payer of the interest is not situated in the UK, HMRC Residency will need satisfactory evidence that the payer has concluded that the payments are to be considered as UK-source and has formed the intention of deducting and accounting for tax accordingly.
> HMRC Residency's claim forms ask claimants to attach copies of relevant loan documentation as part of the normal process. In cases such as those discussed in the previous paragraph, HMRC Residency would also ask claimants to enclose supporting evidence confirming the payers' intentions. This could, for example, be copies of pertinent correspondence with the borrower or other relevant documentation.
> Without the comfort afforded by such supporting documentation, HMRC Residency may well take the view that it should not exercise its discretion under SI 1970/488 to authorise relief at source.
> However, it would then be open to the non-resident payee to make a repayment claim to HMRC Residency once the interest payments have commenced and tax has been deducted. HMRC Residency will be prepared to keep the application for relief at source open and on file pending this eventuality. If the non-resident payee is then able to

9 The point was discussed in more detail in the 6th edition of this work, but the IM passage cited makes this academic.

10 *www.hmrc.gov.uk/cnr/app_dtt.htm#5*.

> forward a certificate of tax deducted completed by the payer, HMRC Residency may then be able to accept that the UK source categorisation of the payments has been established. Assuming that all the other conditions for Double Taxation treaty relief are present, HMRC Residency should then be in a better position both to repay the tax deducted and consider in a more positive light the appropriateness of issuing a Direction under SI 1970/488 for future payments.

This is quite the most absurd procedure which could possibly be imagined, for in many cases the payor will want to argue that the interest is not UK source but (since he can rarely[11] be sure) will want a certificate in case HMRC argue the contrary. Perhaps no-one takes any notice of it in practice.

HMRC say:

> In deciding whether or not HMRC Residency should exercise its discretion in meeting an application for relief at source [ie an application to pay interest without deduction], it must primarily have regard to the risk that the underlying conditions for relief might change over the lifetime of a Direction (which will normally last no longer than five years). Such changes might remove the basis for relief altogether, or in some other way prejudice the amount of tax that the UK is otherwise properly entitled to receive in that period.
>
> Given its duty of care to the UK Exchequer and taxpayer, HMRC Residency have to give particular consideration to the desirability of giving DT treaty relief where transparent concerns such as partnerships and LLCs are concerned. This is because, more often than not, there is a much higher risk that the beneficial owners of such concerns will change. Or that there will be fluctuations in income or profit apportionment that might erode the amount of UK-source income that is attributable to the DT treaty-resident beneficial owners who were identified at the time the application for relief at source was made.
>
> Attention is drawn to the undertaking sought from claimants in the Declaration (Part F of the US/Company 2002) that they will notify HMRC Residency of any changes in the information given on the form. (A similar warning to notify any material changes is given to a UK payer when a Direction is issued to it.)
>
> Without calling into question the good faith of partnership or LLC claimants who give these undertakings, HMRC Residency considers that the problem of monitoring this aspect is particularly acute where there are a very large number of investors, or there is an unfeasible number of layers of participation - partners who

11 The guidance note states complacently that "The meaning of UK-source in this context will not normally give rise to difficulties." The author has not read the HMRC consultation paper on interest; see 11.14.1 (Commentary):

> "The current tests in UK law of whether … payment of interest is made from a UK source are unclear and cause confusion."

> are themselves partnerships, which contain yet more transparent partners.
> For these reasons, although HMRC Residency is willing to entertain any application for relief at source from partnerships or LLCs, it should be understood that it is likely to give relief in this way chiefly where:
> * HMRC Residency are able to accept satisfactory assurances about the monitoring and notification of membership from the claimant concern.
> * The number and type of the concern's membership is not a problem in the first place - for example, a small and fixed number of participators, such as US corporations engaged in a joint venture. Or where the concern is the business arm of a small number of joint intellectual property owners such as a band or similar collaborative venture.
> * In response to a successful representation of special considerations or factors that would allow us to decide that relief may safely be given in this form.
>
> Each case will be considered on its merits.
> Otherwise, HMRC Residency will consider giving relief only by meeting discrete repayment claims.[12]

Although this comment is made in relation to the USA DTT, it should apply generally.

If interest is paid before a notice of non-deduction is obtained, tax deducted at source can be reclaimed by the creditor. If the loan agreement provided for grossing up where tax is deducted at source, the creditor may compensate the debtor for over-payment).

29.7 Withholding tax on interest from deposit-takers

The legislation is in chapter 2 part 15 ITA. HMRC refer to this as the tax deduction scheme for interest ("TDSI") but I prefer not to use that label as this is only one of the three tax deduction schemes for interest discussed in this work. HMRC have issued 139 pages of guidance notes for deposit-takers.[13] This contains much interesting material which is not set out here for reasons of space.

Section 851 ITA provides:

> (1) This section applies if—
> (a) a deposit-taker or building society makes a payment of interest on an investment (see section 855(1)), and
> (b) when the payment is made, the investment is a relevant

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12 "HMRC Residency Double Taxation Guidance Note 3 partnerships and LLCs claiming relief under the 2002 UK/USA DTC."

13 February 2009, accessible *www.hmrc.gov.uk/tdsi/guidance-notes.pdf.*

investment (see section 856).

(2) The deposit-taker or building society must, on making the payment, deduct from it a sum representing income tax on it at the savings rate in force for the tax year in which it is made.

Section 852 ITA authorises exceptions to be made by statutory instrument. Sections 853 and 854 ITA provide an elaborate definition of "deposit-taker" but for present purposes it is sufficient to note that the expression includes banks.

29.7.1 *Investment and deposit*

Section 855 ITA provides commonsense definitions of these terms:

(1) In this Chapter "investment" means—
- (a) a deposit with a deposit-taker,
- (b) a deposit with a building society,
- (c) shares in a building society, or
- (d) a loan to a building society.

(2) In this Chapter "deposit" means a sum of money paid on terms which mean that it will be repaid (with or without interest)—
- (a) on demand, or
- (b) at a time or in circumstances agreed by or on behalf of the person who pays it and the person who receives it.

29.8 Relevant investment

The expression "relevant investment" is a label which brings in a number of rules. Section 856 ITA provides:

856 Investments which are relevant investments

(1) An investment is a relevant investment for the purposes of this Chapter if it meets—
- (a) the individual interest condition (see subsection (3)),
- (b) the Scottish partnership condition (see subsection (4)),
- (c) the personal representative condition (see subsection (5)), or
- (d) the settlement condition (see subsection (6)).

(2) But an investment is not a relevant investment if any of sections 858 to 870 prevent it from being a relevant investment.

29.8.1 *Individual interest condition*

Section 856(3) ITA provides:

> An investment meets the individual interest condition if the only persons beneficially entitled to interest on the investment are individuals.

29.8.2 *Scottish partnership condition*

Section 856(4) ITA provides:

> An investment meets the Scottish partnership condition if—
> (a) a Scottish partnership is beneficially entitled to all interest on the investment, and
> (b) that partnership consists only of individuals.

It is difficult to see the need for this since a Scottish partnership is transparent for IT purposes. However, it does no harm.

29.8.3 *PR condition*

Section 856(5) ITA provides:

> An investment meets the personal representative condition if personal representatives are entitled to any interest on the investment and they receive it in that capacity.

29.8.4 *Settlement condition*

Section 856(6) ITA provides:

> An investment meets the settlement condition if
> [a] all interest on the investment is income arising to the trustees of a discretionary or accumulation settlement and
> [b] they receive it in that capacity.

The key term here is "discretionary or accumulation settlement". Section 856(6)[b] seems to me otiose, though it does no harm. Section 873 ITA provides the definition:

(1) A settlement is a discretionary or accumulation settlement for the purposes of this Chapter if any income arising to the trustees would (unless treated as income of the settlor) be to any extent income within subsection (2) for the tax year in which it arises.
(2) Income is within this subsection so far as it is—

(a) accumulated or discretionary income as defined in section 480 (other than income arising under a trust established for charitable purposes only or an unauthorised unit trust in relation to which section 504 applies), or

(b) an amount of a type set out in section 482 (unless the trust is a unit trust scheme or the amount is income arising under a trust established for charitable purposes only or is excluded by section 481(5)).

29.9 Exceptions for non-residents

29.9.1 *Duty on deposit-taker*

Section 857 ITA provides:

857 Investments to be treated as being or as not being relevant investments
(1) A deposit-taker or building society must treat every investment with it as a relevant investment unless satisfied that the investment is not a relevant investment.
(2) If a deposit-taker or building society is satisfied that an investment is not a relevant investment, it may continue to treat the investment as not being a relevant investment until subsection (3) applies.
(3) This subsection applies when the deposit-taker or building society has information which can reasonably be taken to indicate that the investment is or may be a relevant investment.

The TDSI guidance notes provide:

Giving effect to the NOR declaration
4.37 When Financial Institutions receive a NOR declaration which is fully completed in the form currently prescribed (or approved) by HMRC, they must satisfy themselves that there are no grounds for believing that the investor is or may be ordinarily resident in the UK or that the trustees are or may be resident in the UK, or that any of the beneficiaries are or may be ordinarily resident/resident, as appropriate. If they are so satisfied they must pay interest without deducting BRT.

If Financial Institutions have any information suggesting that the investor is or may be ordinarily resident in the UK, or that the trustees are or may be resident, or that any of the beneficiaries are or may be ordinarily resident/resident, they must not pay interest without deduction of BRT unless and until they have satisfied themselves that the investor is NOR or that the trustees are not resident and the beneficiaries are NOR/not resident, as appropriate.

The NOR supervisor normally carries out these checks on behalf of the Financial Institution. Financial Institutions must therefore put in place systems (clerical or computer-based) for ensuring that all relevant information is made available to the NOR supervisor. In particular all accounts in the branch to which the investor or trustees/beneficiaries is/are party, whether deposit or loan accounts (including mortgage accounts), and any such other accounts which are known to the branch should be reviewed. Examples of relevant information which could cast doubt on the validity of the declaration are

- a UK business in which the investor/trustees/beneficiaries appear to participate actively,
- a UK address or postal directions,
- an overseas PO Box or "c/o" address,
- a BFPO address, and
- a notification that the account is the subject of a third party mandate in favour of

a UK resident or used as security for borrowing by UK residents or for borrowing in respect of the purchase of the UK property.

In making his or her decisions the NOR supervisor must not ignore information which comes to his or her attention by personal knowledge or otherwise. An example of this might be frequent or regular personal visits to the bank, cash transactions etc. The Financial Institution should put procedures in place so that information of a similar nature which comes to the knowledge of an employee who is responsible for handling any NOR accounts should similarly be drawn to the NOR supervisor's attention.

It will be unusual for such information to provide conclusive proof that the NOR February 2009 declaration is invalid. However, where the information could reasonably be taken to indicate that the investor may be ordinarily resident in the UK, the trustees may be resident or that any of the beneficiaries may be ordinarily resident/resident, the Financial Institution is obliged to satisfy itself that the evidence does not render the NOR declaration invalid. One way of doing this would be by obtaining written confirmation from the investor. A note of any enquiries made should be kept in the investor's records or the trust records.

It may be possible to resolve doubts which arise without reference to the investor or trustees. For example if the investor is known to be a student in the UK it would be reasonable for him or her to make frequent personal visits to the bank. In such circumstances, no further action need be taken by the NOR supervisor and the NOR declaration may be accepted. NOR supervisors are recommended to retain some record of the decisions.

The continuing obligation

4.38 Once an NOR declaration has taken effect, Financial Institutions must continue to pay interest without deducting BRT unless and until they receive information suggesting that the investor is or may be ordinarily resident in the UK, or the trustees are or may be resident, or any of the beneficiaries are or may be ordinarily resident/resident. This is called the “continuing obligation”. They must put in place systems so that as far as possible all relevant information which can be readily linked to a NOR account is brought to the attention of the NOR supervisor. Relevant information is that which points to a UK connection, for example

- notification of a UK address,
- change of account title,
- applications for credit cards, loans or mortgages suggesting UK residence,
- use of the deposit as security for borrowing by UK residents or for borrowing in respect of the purchase of UK property,
- the grant of third party mandates in favour of a UK resident,
- the grant of a “lien” on the account,
- information which comes to the NOR supervisor's attention by personal knowledge,
- the existence of a UK business in which the investor has an active interest, and February 2009
- frequent or regular personal visits to the Financial Institution, cash transactions in the UK etc.

Where information indicates that the investor is or may be ordinarily resident in the UK or the trustees are or may be resident in the UK, or any of the beneficiaries are or may be ordinarily resident/resident in the UK, as appropriate, strictly the Financial Institution should treat the deposit as a relevant investment immediately and begin to deduct BRT. However, provided the Financial Institution has taken steps to satisfy itself that the investor has remained NOR, and, if necessary, has asked the investor to confirm that he or she has remained NOR (or in the case of trustees or beneficiaries that they are NOR/not resident, as appropriate), the Financial Institution may continue to pay interest without deducting BRT for up to 180 days to enable enquiries to be concluded. In exceptional cases HMRC may allow up to a further 180 days. Any Financial Institutions needing more than 180 days should apply to ...

HMRC recommends that where the matter is resolved without correspondence the NOR Supervisor records why he or she considers that the declaration remains valid.

Where the investor or the trustees is/are unable to satisfy the Financial Institution that a NOR declaration remains valid the Financial Institution should treat the deposit as a relevant investment and deduct BRT. Where the investor has not given all the necessary information within 180 days (or any further period HMRC may allow) the Financial Institution must deduct BRT from any future payments of interest.

Overseas Students

4.39 Students entering the UK for a period of study lasting less than four years are normally treated as not ordinarily resident in the UK. HMRC recommend that institutions make a diary note to review these accounts at the end of 4 years. If, at the end of 4 years, there is still a UK address on the account then you have 180 days to check the position with the investor.

If there is a reply and the investor is now ordinarily resident in the UK the Financial Institution should cancel the form R105 and deduct BRT from future payments of interest. The investor may be eligible to complete a form R85.
If there is no reply and there is still movement on the account. The Financial Institution should cancel the form R105 at the end of 180 days and deduct BRT from future payments of interest.
If there is no reply, no movement on the account and no evidence suggesting the investor is ordinarily resident in the UK interest can continue to be paid gross.

Change of name of investor

4.40 Where the investor changes his or her name, for example by marriage, it is not necessary to replace the NOR declaration but the Financial Institution should ensure there is a clear audit trail. An example of a clear audit trail would be annotating the form with the revised details and endorsing the amendment with date stamp.

Transfer of account between branches

4.41 A new NOR declaration is not required when an account is transferred between branches. But Financial Institutions should ensure that there is a clear audit trail back to the original NOR declaration.

29.9.2 *Non-resident individual*

Section 858 provides:

858 Declarations of non-UK residence: individuals

(1) This section applies to an investment with a deposit-taker or building society which meets the individual interest condition in section 856(3).
(2) The investment is not a relevant investment if—
- (a) an appropriate person[14] has made the declaration set out in subsection (3) to the deposit-taker or building society,
- (b) the declaration contains the undertaking set out in subsection (4),[15]
- (c) the declaration contains the name and principal residential address of the individual or (as the case may be) each of the individuals entitled to the interest,
- (d) the declaration contains such other information as the

14 Section 857(5) provides:
"In this section 'appropriate person' means—
(a) a person who is beneficially entitled to interest on the investment, or
(b) a person to whom any such interest is payable.

15 Section 858(4) provides:
"The undertaking is an undertaking by the person making it to notify the person to whom it is made if any individual in respect of whom it is made becomes ordinarily UK resident."

Commissioners for HMRC may reasonably require, and

(e) the declaration is in such form as the Commissioners may prescribe or authorise.

Section 858 then sets out the terms of the declaration:

(3) The declaration is that, at the time when the declaration is made—

(a) the person who is beneficially entitled to the interest is not ordinarily UK resident, or

(b) (as the case may be) all the persons who are so entitled are not ordinarily UK resident.

I refer to this (adopting the terminology of the TDSI guidance note) as "**NOR declaration**". The TDSI guidance notes provide:

UK address

4.9 Where the declaration shows a residential address in the UK it should not be regarded as acceptable unless it is known that the investor is temporarily in the UK (for example, as a student) and the address given is for the time being his or her principal residential address.

Incompatible evidence

4.10 If there is information which appears incompatible with the investor's status as indicated in his or her NOR declaration (for example, he or she appears to have a business in the UK), the Financial Institution cannot be satisfied that the deposit is a relevant investment and is obliged to seek further clarification from the investor of his status before the NOR declaration can be acted upon. The Financial Institution should contact the investor seeking an explanation of why he or she considers themselves to be not ordinarily resident. See also paragraph 4.37. If the investor is able to satisfy the Financial Institution that the declaration is valid, the Financial Institution can accept the declaration and need take no further action. Financial Institutions are recommended to retain some note of the enquiry. If the investor is unable to satisfy the Financial Institution that his or her NOR declaration is valid the Financial Institution should deduct BRT from any interest paid on the deposit.

Joint accounts

4.11 Any investor in a joint account may sign the form R105 on behalf of all the other investors. But if that investor ceases to be a party to the account, for example, if he or she dies, a new NOR declaration will be required. Financial Institutions can only pay interest on a joint account without deduction of tax if the investors are eligible to receive interest without deduction of tax for the same reason. For example, where one investor is entitled to register using form R85 and another investor is entitled to sign an NOR declaration on form R105 interest must be paid net. In other words, a mixture of a registration on form R85 and form R105 is not allowed on the same joint account.

Death of an investor

4.12 If one party to a joint account dies or otherwise leaves the account, a new declaration is not required unless that person was the only signatory of the NOR declaration.

29.9.3 *Non-resident Scottish partnership*

Section 859 ITA contains an exception for non-resident Scottish partnerships, which is not discussed here.

29.9.4 *Non-resident PRs*

Section 860 ITA provides:

860 Declarations of non-UK residence: personal representatives

(1) This section applies to an investment with a deposit-taker or building society which meets the personal representative condition in section 856(5).

(2) The investment is not a relevant investment if—

- (a) an appropriate person has made the declaration set out in subsection (3) to the deposit-taker or building society,
- (b) the declaration contains such information as the Commissioners for Her Majesty's Revenue and Customs may reasonably require, and
- (c) the declaration is in such form as the Commissioners may prescribe or authorise.

(3) The declaration is that the deceased was not ordinarily UK resident immediately before the deceased's death.

(4) In this section "appropriate person" means—

- (a) any of the personal representatives who are entitled to receive interest on the investment, or
- (b) a person to whom any such interest is payable.

The actual residence of the PRs for IT purposes is not relevant.

The TDSI guidance notes provide:

R105(PR) – personal representatives

4.21 Form R105 completed by an investor before his or her death will remain in force after the date of death during the winding up of the estate. But if the personal representatives open an account in their own names, or transfer funds into an account in their own names, that account will not be an NOR account, unless and until the personal representatives make a NOR declaration. Personal representatives must make their declaration on

- a photocopy of the R105(PR) (see Appendix 5), or
- a downloaded copy of the R105(PR) from the HMRC website
- a substitute form which has been approved by the HMRC.

R105(PR) – who can sign?

4.22 In the case of an investment forming part of a deceased person's estate the form can be signed by either

- the personal representative of the deceased (or legal equivalent in the country where they live), or
- the person to whom the interest is paid.

The person signing the declaration should tick the relevant box above the signature to show whether or not he or she is the personal representative (or legal equivalent in that country).

It is the NOR status of the deceased which is important, and not that of the personal representative. Therefore, it is acceptable for a personal representative who is ordinarily resident in the UK to complete the declaration in respect of a deceased NOR investor.

29.9.5 *Non-resident trusts*

Section 861 ITA provides:

861 Declarations of non-UK residence: settlements

(1) This section applies to an investment with a deposit-taker or building society which meets the settlement condition in section 856(6).

(2) The investment is not a relevant investment if—

(a) an appropriate person has made the declaration set out in subsection (3) to the deposit-taker or building society,

(b) the declaration contains the undertaking set out in subsection (4),

(c) the declaration contains such information as the Commissioners for Her Majesty's Revenue and Customs may reasonably require, and

(d) the declaration is in such form as the Commissioners may prescribe or authorise.

(3) The declaration is that, at the time when the declaration is made—

(a) the trustees who are entitled to the interest are non-UK resident (see section 475), and

(b) no person who is a trustee has reasonable grounds for believing that any beneficiary under the settlement is—
  (i) an individual who is ordinarily UK resident,
  (ii) a company which is UK resident, or
  (iii) a Scottish partnership any of the partners of which is an individual who is ordinarily UK resident or a company which is UK resident.

(4) The undertaking is an undertaking by the person making it to notify the person to whom it is made if—

(a) the trustees become UK resident,
(b) an individual in respect of whom it is made becomes ordinarily UK resident,
(c) a company in respect of which it is made becomes UK resident,
(d) an individual partner in any Scottish partnership in respect of which it is made becomes ordinarily UK resident,
(e) a company partner in any Scottish partnership in respect of which it is made becomes UK resident,
(f) a partner who is an ordinarily UK resident individual or a UK resident company joins any Scottish partnership in respect of which it is made, or
(g) a person within any of sub-paras (i) to (iii) of subsection (3)(b) becomes or is found to be a beneficiary under the settlement to which the declaration relates.

(5) In this section "appropriate person" means—

(a) any person who is a trustee entitled to receive interest on the investment, or
(b) a person to whom any such interest is payable.

The term "beneficiary" is defined in s.875 ITA:

(3) A person is a beneficiary under a discretionary or accumulation settlement for the purposes of this Chapter if—

(a) the person is an actual or potential beneficiary under the settlement, and
(b) condition A or B is met in relation to the person.

(4) Condition A is that the person is, or will or may become, entitled under the settlement to receive some or all of any income under the settlement.

(5) Condition B is that some or all of any income under the settlement may be paid to or used for the benefit of the person in the exercise of a discretion conferred under the settlement.

(6) The references in subsections (4) and (5) to any income under the settlement include a reference to any capital under the settlement so far as it represents amounts originally received by the trustees as income.

The definition is the same as in 30.6.1 (“Beneficiary”).

The form is Form R105 (DAT).

The TDSI guidance notes provide:

> **Interest in possession trusts**
> 2.9 ... If the beneficial owner of the interest is an individual, (and therefore the deposit is a relevant investment) the account cannot be registered with a form R85. The reason is that the certificate must be given by person in whose name the investment is held who is beneficially entitled to the payment. In this case the investment is held by the trustee, and as the trustee is not beneficially entitled to the payment they cannot complete a form R85.
>
> **R105 (DAT) – change of trustees or beneficiaries**
> 4.33 Where the Financial Institution becomes aware that there has been a change of trustee or beneficiary, it may continue to pay interest without deduction of BRT if it February 2009 has no reason to believe
> - that the trustees are or may be resident, or
> - a beneficiary is or may be ordinarily resident/resident in the UK, or
> - a new beneficiary is or may be ordinarily resident/resident in the UK.

29.10 Beneficial entitlement

It is necessary to identify the person who is beneficially entitled since the exemption depends on the residence of that person.

Suppose:

(1) interest is paid to a settlor-interested trust; and
(2) the trustees are outside the UK and the settlor is in the UK.

At first sight there is no obligation to deduct as the interest is treated as income of the settlor “and of the settlor alone”. Following the deeming, the payment should be treated as paid to the settlor. Conversely, if the settlor is outside the UK, there is an obligation to deduct even if the trustees are in the UK. It is suggested that that is the correct view. This is consistent with the position for the non-resident’s withholding rule

It appears that HMRC accept this.

TDSI guidance notes[16] para 2.3 provide:

> **Anstalts & Stiftungs**
> [1] Anstalts and Stiftungs are Liechtenstein business entities which are fiscally opaque....
> [2] The current HMRC view is that Stiftungs are Trusts for UK tax purposes. For TDSI purposes, the deposit should be considered to belong to the settlor[17] and the TDSI treatment depends on the nature of the settlor – so if the settlor is an individual, BRT [basic rate of tax] must be deducted.
> [3] If the settlor can show that they have not retained an interest, the Financial Institution can treat the Stiftung as an interest in possession trust (see paragraph 2.9) and the TDSI position will depend on the nature of the beneficiary. If the beneficiary is an individual, BRT must be deducted.

29.10.1 *Policy and practical use of non-resident exceptions*

The ITH para 876 explains the policy reason behind the exemption:

> There were moreover compelling policy considerations. An attempt to tax the interest could have harmed the balance of payments by discouraging foreigners from putting their money into the UK. For the same reason no attempt has been made to require banks to deduct tax from interest paid to non-residents and interest belonging to persons not ordinarily resident is now excluded from the arrangements for deduction of tax from bank interest.

Since the conditions of all these non-resident exceptions could be onerous, I would have thought that the easier course would be to deposit funds with a non resident deposit-taker and not to use a UK bank. IHT may also be a reason for avoiding UK bank deposits. The remittance basis (and the temporary non-residents rules) may be another reason.

29.10.2 *Other exceptions*

The following exceptions are mentioned for completeness and not

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16 *www.hmrc.gov.uk/tdsi/guidance-notes.pdf* For TDSI (tax deduction scheme for interest) see 29.7 (Withholding tax on interest from deposit-takers).

17 [Author's footnote] It is assumed that the Stiftung is a settlor-interested trust.

discussed here:

- Client accounts (s.863 ITA)
- Qualifying uncertificated eligible debt security units: s.864 ITA
- Qualifying certificates of deposit: s.865 ITA
- Qualifying time deposits: s.866 ITA
- Lloyds premium trust funds: s.867 ITA
- Sale and repurchase of securities: s.869 ITA
- Loans made by deposit takers: s.870(1)(a) ITA
- Debt on a security listed on a recognised stock exchange: s.870(1)(b) ITA
- Debt on a debenture issued by the deposit-taker: s.870(1)(c) ITA

29.11 EU Interest and Savings Directive

The relevant law and practice is found in:

(1) European Directive 2003/48/EC on taxation of savings income in the form of interest payments ("EUSD") which applies to EU states.
(2) International agreements made by individual tax havens.[18]
(3) Domestic legislation in each state (where the state has chosen to enact domestic legislation to impose the rules agreed in the Directive or agreement).[19]
(4) Guidance notes issued by each state.[20]

A full discussion requires many volumes to itself. Proposals are underway

18 These are:
(1) UK Crown Dependencies: the Channel Islands and the Isle of Man.
(2) UK Overseas Territories: Anguilla, Montserrat, British Virgin Islands, Turks and Caicos Islands, Cayman Islands.
(3) Dependent Territories of the Netherlands: Netherlands Antilles and Aruba.
(4) Other countries: Switzerland, Andorra, Liechtenstein, Monaco and San Marino.

19 In the UK this has been done by the Reporting of Savings Income Information Regs 2003 (SI 3297).

20 In the UK see *www.hmrc.gov.uk/esd-guidance/guidance.htm*. But UK resident foreign domiciliaries would not be concerned about UK law.

to amend the law.[21]

In the following discussion, "**an ISD state**" is a state where Directive rules applies.

In short, the rules apply when a "paying agent"[22] established in one ISD state pays "interest"[23] to an individual who is "resident"[24] in another ISD state. The duties of the paying agent depend on the state in which the paying agent is established: they are not identical in every state.

A UK resident foreign domiciliary will most often be affected where:

(1) he receives interest from a paying agent in Belgium, Luxembourg, Austria, or a tax haven in a jurisdiction which has agreed to apply Directive rules; or
(2) trustees of a transparent *Baker*-type IP trust[25] in such a jurisdiction pay interest to a life tenant resident in the UK.

The paying agent has two choices:

(1) If the individual gives authority, the trustees may report the interest payments to HMRC in the UK.
(2) Alternatively the trustees must impose a withholding tax (also called a retention tax) on the payment of interest.[26]

Many jurisdictions have taken the view before 2008/09 that the withholding/disclosure requirement does not apply when a payment of interest is made to a UK resident foreign domiciled individual, if the

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21 See Proposal for a COUNCIL DIRECTIVE amending Directive 2003/48/EC, COM(2008) 727 final 2008/0215 (CNS), accessible *http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savings_tax/savings_directive_review/COM(2008)727_en.pdf*

22 This term is elaborately defined: Art.4 EUSD. It includes trustees but not (in short) individual borrowers not carrying on business.

23 This term is also elaborately defined: Art.6 EUSD.

24 This term is defined in Art.3(3) EUSD.

25 Payment from a discretionary trust or non-transparent IP trust is not "interest" and so it does not require withholding or disclosure. The EUSD will eventually be extended to cover this.

26 The states that operate this tax are: Austria, Belgium, Luxembourg, Jersey, Guernsey, Isle of Man, British Virgin Islands, Netherland Antilles, Turks & Caicos, Switzerland, Andorra, San Marino, Liechtenstein and Monaco.
The EU withholding tax is in addition to any foreign tax that is withheld.

interest is not remitted (and so not subject to UK tax).[27] This is a purposive construction, as the point is not made in the text of the agreements and whether it is correct seems very doubtful. HMRC do not agree, but the point is not within their jurisdiction, and they actually benefit from this practice as they do not have to allow a tax credit. This point ultimately raises questions of EU or international law, but not on any view questions of UK law.

However the EU have taken action on this point. The report entitled "Report from the Commission to the Council in accordance with Article 18 of Council Directive 2003/48/EC on taxation of savings income in the form of interest payments " states:

> The Commission has so far opened two infringement procedures concerning the implementation of the Directive. A letter of formal notice has been sent inviting the two MS concerned to submit their observations. "One case" concerns the non-application of the Directive

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27 The Channel Islands and the Isle of Man take this view. See e.g. para 32 of the Isle of Man Treasury guidance notes accessible
www.gov.im/lib/docs/treasury/incometax/guidance.pdf
"32. In deciding to whom the retention tax will need to be applied the focus should be on the ultimate aim of the Directive which is to enable savings income in the form of interest payments made in one Member State to beneficial owners who are individuals resident in another Member State to be made subject to effective taxation in accordance with the laws of the latter Member State. The emphasis should be on individuals, and also on those individuals who are not only resident in a Member State but are persons subject to effective taxation in accordance with the laws of the Member State. It is therefore consistent with the aims of the Directive, and therefore of the Agreements into which the Crown Dependencies have entered, that the retention tax will not apply to interest payments made to …
- a trust (unless, as in the case of an interest in possession trust, a relevant beneficiary has the immediate and absolute entitlement to an interest payment);
…
- an individual where it is known to the paying agent that they benefit in their Member State of residence from an exemption from income tax; or where because no interest is remitted to the individual no liability to income tax arises in their Member State of residence."

Switzerland agrees: see *Eidgenössische Steuerverwaltung: Wegleitung zur EU-Zinsbesteuerung* (Swiss Federal Tax Authority Guidelines) § 37.
The operation of this practice from 2008/09 is a little more difficult, because the remittance basis depends on making a claim and at the time the interest is paid the claim will not yet have been made. But the practice will probably continue to be applied in cases where the individual confirms that he intends to make a remittance basis claim.

> where the beneficial owner has "non-domiciled" status. The MS concerned considers that the Directive is not applicable if the beneficial owner is exempted in his MS of residence.[28]

The MS concerned are Luxembourg and Belgium. The letter of formal notice is not a public document; it will be interesting to see how the matter develops.[29] The proposed renegotiation of the EUSD may resolve the issue, but that will take years to come to fruition.

In practice, if the paying agent, guided no doubt by the local authorities, take the view that the duty of withholding/disclosure does apply to unremitted interest, the individual will usually consent to the disclosure. Then there will be no withholding tax. No difficulty will normally arise out of that disclosure. The Directive and supplemental agreements are designed to prevent criminal tax evasion, not lawful tax planning of the kind considered in this book.

29.11.1 *Credit for withholding tax*

If tax is withheld, 75% of it is paid to the Member State where the beneficiary is resident.[30] But the beneficiary is entitled to a tax credit for 100% of the tax withheld.[31]

HMRC now accept that the credit is applicable even if it relates to unremitted income (un)taxed on the remittance basis.[32] The Foreign Notes for 2007/08 provide:

> [1] If you have claimed for your foreign income to be taxed on the remittance basis then the amount of income remitted is calculated by including the appropriate proportion of the SWT.
>
> [2] You are still able to claim the whole amount of SWT deducted in the year in column D.
>
> **Example 3**
>
> Adam received interest of £1,000 from Jersey. Special Withholding Tax (SWT)

28 COM(2008) 552 final accessible *eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2008:0552:FIN:EN:DOC*

29 For press-releases on on-going procedures see *ec.europa.eu/taxation_customs/common/infringements/infringement_cases/index_en.htm*

30 Art.12.

31 Art.14.

32 HMRC changed their mind in Tax Bulletin 84 (discussed in the 6th edition of this book).

of £150 was withheld. Adam is non-domiciled in the UK so claims for his foreign income to be assessed on the remittance basis. £425 of the interest was received in the UK.

Interest received in the UK	£425
Add SWT 425/850 x 150	£ 75
	£500
Enter on page F2 of the Foreign Pages	
Amount before tax (Column B)	£500
Special withholding tax (column D)	£150

Point [2] is right[33] but point [1] is doubtful. If a credit is given against tax, the amount credited is not received in the UK and so not remitted. If that is correct the amount received in the UK is (in the example) £425, not £500.

If the credit takes the form of a refund, received in the UK, it is considered that the amount received is derived from the foreign interest, and so is regarded as remitted.

33 But if countries adopt the view that no withholding applies to unremitted income, this issue will not arise.

CHAPTER THIRTY

LOANS FROM NON-RESIDENT COMPANIES

30.1 Advantages of loans from non-resident companies

A dividend (or other income distribution) from a non-resident company will often cause income tax problems. If the dividend is received by a UK resident foreign domiciled individual, directly or through an IP trust, it will be taxable on the remittance basis. If it is received by a foreign discretionary trust or company, it will be income for the purposes of s.624 ITTOIA and the TAA provisions. By contrast a loan, even if interest-free, will not constitute an income receipt and will avoid these problems. Loans therefore seem an attractive method of extracting funds from companies. However, they raise tax issues of their own.

The following issues are discussed elsewhere: a loan may be a benefit for the purposes of s.731 ITA.[1] A loan to a transferor or settlor will be a capital sum within s.727 ITA[2] and s.633 ITTOIA.[3] The receipt of the loan in the UK may affect the s.624, s.720 or s.731 foreign domicile defences.[4] The receipt of a loan in the UK may constitute a taxable remittance, if the sum loaned represents RFI or chargeable gains of the individual. The liability to repay the loan may not be deductible for IHT purposes.[5]

I assume that the company is not UK resident when the loan is made.

Loans *to* non-resident companies raise different issues, not discussed here.

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1 See 19.4.4 (Interest-free loan and enjoyment of asset in kind).

2 See 18.11 (Transferor receives capital sum).

3 See 16.16 (Settlor receives capital sum).

4 See 16.5 (Section 624 remittance basis); 18.13 (Section 720 foreign domicile defence); 19.33 (Section 731 foreign domicile defence).

5 See 47.1 (IHT deduction for debts).

30.2 Non-tax aspects

The loan should be documented by a written agreement made at the time of the loan. It should be recorded in the company's accounts.

Take care the loan does not accidentally become statute-barred.

The company law restrictions on loans to directors and connected persons will need to be reviewed. This will depend on the applicable law of the company.

If the company is held by a trust, the trustees need to consider whether they can properly permit the company to make the loan.

30.3 Section 419 ICTA: loans to participators

Section 419 ICTA imposes a charge where a close company lends money to a participator. There is no charge under this section provided the company was not UK resident (and so not "close") at the time the loan was made. It does not matter if the company later becomes UK resident.

30.4 Section 418 ICTA: benefits to participators

Section 418 ICTA imposes a charge where a "close company incurs expense in or in connection with the provision for any participator of ... benefits or facilities of whatever nature". However a close company does not "incur expense" in making a loan or in leaving the loan outstanding, and so there will be no charge under this section. Also a non-resident company is not "close".

30.5 Employment-related loan

Section 175(1) ITEPA provides:

> The cash equivalent of the benefit of an employment-related loan is to be treated as earnings from the employee's employment for a tax year if the loan is a taxable cheap loan in relation to that year.

This will in principle apply on a loan from a company to an employee, director, or shadow director[6] (or a relative of such a person). A discussion of the meaning of "taxable cheap loan" and the quantum of the charge is outside the scope of this book. For DTT relief see 54.27 (DTT defence to BIK charge).

30.5.1 *Remittance basis employee*

The BIK earnings of an employment-related loan may be chargeable overseas earnings if (in short) the duties of the employment are performed wholly outside the UK. If so, it is suggested that the earnings cannot be remitted so no tax charge can arise.[7]

30.5.2 *Loan to shadow director: HMRC practice*

Where living accommodation is provided by a company, HMRC say that they are keen to take the point that the occupier of the property may be a shadow director of the company, so that a benefit in kind charge arises.[8] In relation to interest-free loans from offshore companies, the same technical point arises. However in this case HMRC do not seem to argue the point. There are various possible explanations of this discrepancy.

Of course a person who borrows interest free from a company is not necessarily a shadow director of that company. Perhaps the person occupying a property purchased by the company is more at risk of becoming a shadow director, because the company's acts to acquire the property and licence the individual to occupy may ultimately be at the direction of the individual. By contrast, the decision to extract funds from the company by way of loan (as opposed, say, to distribution) is less likely to be at the direction of the individual. So the explanation may be that borrowers (unlike occupiers) are less likely to be shadow directors, But it is of course a question of fact in each case.

The motivation for (purporting to) take the living accommodation point may be to discourage IHT planning on the family home, not the collection of income tax. That is a second possible explanation.

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6 See 54.12 (Who is a shadow director?).

7 See 54.25 (Benefit in kind remittance basis). If that is wrong, imponderable questions arise as to what happens if the money lent is remitted here and spent. Contrast 19.35.1 (Interest-free or low-interest loan).

8 See 54.11 (Shadow directors).

30.6 Meaning of "employment-related loan"

30.6.1 *"Loan"*

Section 173(2)(a) ITEPA provides:

> "loan" includes any form of credit,

EIM para 26108 provides:

> **26108. Meaning of loan** [March 2007]
> Loan means more than just lending money. It includes any form of credit. It follows that any kind of advance by reason of the employment is covered. For example, any amount shown in the employer's books or records as owed by an employee will count as a loan.
> *Grant v Watton*
> The case of *Grant v Watton* (71 TC 333) concerned credit extended by a company of which Grant was a director, to his sole trade and later to a partnership in which Grant was the general partner. In the High Court Pumfrey J. considered the meaning of credit –
>
> > ".... credit is granted where payment is not demanded until a time later than the supply of goods to which the payment relates. Credit is the deferral of payment of a sum which, absent agreement, would be immediately payable."
>
> Regarding the application of Section 175 ITEPA 2003 to an overdrawn director's loan account see EIM26505.

30.6.2 *"Making" a loan*

Section 173(2)(b) ITEPA provides:

> references to making a loan (and related expressions) include arranging, guaranteeing or in any way facilitating a loan.

EIM 26110 [March 2007] summarises this and continues:

> **Loan made by a third party – employee benefit trust**
> It is not uncommon for a third party, such as an employee benefit trust (EBT), to make a loan to a beneficiary who is also an employee of the employer which is associated with the EBT. It is sometimes suggested that the loan is not an "employment-related loan" (EIM26113) because

> the definition of that term does not include a loan provided by a third party.
> Whilst it is true that the definition includes no reference to a third party loan provider, HMRC does not accept that the loan is not an employment-related loan. The definition of "employment-related loan" includes a loan made by an employee's employer. As "making" a loan includes "in any way facilitating" a loan, if the employer provides the money to fund the EBT, the employer is regarded as making the loan. Consequently for the purposes of the loan benefit rules, the EBT is ignored and the loan is treated as made directly by the employer to the employee. It follows that the loan is an employment-related loan.

Suppose:

(1) A company is held by a trust, and lends funds to the trustees ("loan 1").
(2) The trustees lend funds to a beneficiary who is a shadow director ("loan 2").

At first sight this would not be an employment-related loan because it is not made by the "employer". But if loan 1 is made in order to allow the trustees to lend to the beneficiary, it might be said that the company has facilitated loan 2. The same applies to a back-to-back loan, i.e. if the company deposits funds with a bank, the trustees borrow from the same bank on the security of that deposit, and the trustees then lend to the beneficiary.

Section 174(4) ITEPA provides:

> References in this section to a loan being made by a person extend to a person who—
> (a) assumes the rights and liabilities of the person who originally made the loan, or
> (b) arranges, guarantees or in any way facilitates the continuation of a loan already in existence.

EIM para 26111 provides:

> **Loans taken over from another person**
> If the rights over an existing loan are taken over by another person the loan will remain within the charge if it was within the charge when it was first made.

A loan within the scope of the charge cannot be removed from it by the original lender handing his or her rights over to another person.
But a loan that was not within the charge when it was first made can be brought within it if it is taken over by a person mentioned in EIM26113.

30.6.3 *"Employment-related"*

"Employment-related" loan is defined in s.174 ITEPA:

174 Employment-related loans
(1) For the purposes of this Chapter an employment-related loan is a loan—
(a) made to an employee[9] or a relative[10] of an employee, and
(b) of a class described in subsection (2).
(2) For the purposes of this Chapter the classes of employment-related loan are—

A A loan made by the employee's employer.
B A loan made by a company or partnership over which the employee's employer had control.
C A loan made by a company or partnership by which the employer (being a company or partnership) was controlled.
D A loan made by a company or partnership which was controlled by a person by whom the employer (being a company or partnership) was controlled.
E A loan made by a person having a material interest[11] in—
  (a) a close company which was the employer, had control over the employer or was controlled by the employer, or
  (b) a company or partnership controlling that close company.

(3) In this section—
"employee" includes a prospective employee, and
"employer" includes a prospective employer.
...
(5) A loan is not an employment-related loan if—
(a) it is made by an individual in the normal course of the individual's domestic,

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9 For the definition of "employee" see 54.7 ("Employer", "employee" and "employment").
10 s.174(6) ITEPA defines "relative":
For the purposes of this section a person ("X") is a relative of another ("Y") if X is—
(a) Y's spouse or civil partner,
(b) a parent, child or remoter relation in the direct line either of Y or of Y's spouse or civil partner,
(c) a brother or sister of Y or of Y's spouse or civil partner, or
(d) the spouse or civil partner of a person falling within para (b) or (c).
11 "Material interest" is defined in s.68 ITEPA.

family or personal relationships, or
(b) it is made to a relative of the employee and the employee derives no benefit from it.

"Control" has the meaning in s.995 ITA: see s.719 ITEPA.

What if a loan is made to someone who is not an employee (as defined) but later becomes a shadow director? At first sight, leaving an existing loan outstanding would not give rise to a tax charge even after the borrower becomes a shadow director. However, if the loan is repayable on demand, not calling in the loan amounts to "any form of credit". Thus there will be an income tax charge on the benefit in kind of the interest-free loan if a borrower becomes a shadow director (and so becomes an "employee").

What is the position if a loan is made to a shadow director who ceases to be a shadow director? There is no charge on a loan to a former employee.

30.7 Transactions in securities

30.7.1 *Introduction*

The "lengthy and complicated"[12] provisions of Chapter 1 Part 13 ITA require a book to themselves. The following discussion concentrates on points relevant to loans.

Section 684(1) ITA provides:

> This section applies to a person in respect of a transaction in securities or two or more such transactions if the person is in a position to obtain or has obtained an income tax advantage—
> (a) in circumstances where any of the provisions specified in subsection (2) applies in relation to the person, and
> (b) in consequence of—
> (i) the transaction, or
> (ii) the combined effect of the transactions.

Section 684 raises the following issues:

(1) Is there a transaction in securities?
(2) Does a person obtain an income tax advantage?

12 *IRC v Laird Group* [2003] STC 1349 at [13].

(3) Does he obtain the tax advantage in circumstances within s.684(2) ITA (Circumstance A to E)?
(4) Does he obtain the tax advantage in consequence of the transaction in securities?
(5) Does the escape clause apply?

30.8 "Transaction in securities"

This expression is defined in s.713 ITA:

> "transaction in securities" means transactions, of whatever description, relating to securities, and in particular—
> (a) the purchase, sale or exchange of securities,
> (b) issuing or securing the issue of new securities,
> (c) applying or subscribing for new securities, and
> (d) altering or securing the alteration of the rights attached to securities.

"Securities" is defined in s.713 ITA:

> "securities"—
> (a) includes shares and stock, and
> (b) in relation to a company not limited by shares (whether or not it has a share capital) includes also a reference to the interest of a member of the company as such, whatever the form of that interest.

A debenture is a security.[13] However, a simple interest-free loan is not in principle a "security" and so making such a loan is not a transaction in securities.[14]

30.9 "Income tax advantage"

"Income tax advantage" is defined in s.683 ITA:

> (1) In this Chapter "income tax advantage" means—

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13 *IRC v Parker* 43 TC 396.

14 For a discussion of the meaning of "security", see *Gore-Browne on Companies* para 17.3; *Interests in Securities*, Benjamin, 1st ed., 2000, para 1.02 and 1.20.

> (a) a relief from income tax or increased relief from income tax,[15]
> (b) a repayment of income tax or increased repayment of income tax,
> (c) the avoidance or reduction of a charge to income tax or an assessment to income tax, or
> (d) the avoidance of a possible assessment to income tax.
> (2) For the purposes of subsection (1)(c) and (d) it does not matter whether the avoidance or reduction is effected—
> (a) by receipts accruing in such a way that the recipient does not pay or bear income tax on them, or
> (b) by a deduction in calculating profits or gains.

A loan does not fall within (1)(a) or (b). What is "avoidance of tax" within 1(c) and (d)? Lord Wilberforce said in *IRC v Parker*:

> The paragraph, as I understand it, presupposes a situation in which
> [1] an assessment to tax, or increased tax, either is made or may possibly be made,
> [2] that the taxpayer is in a position to resist the assessment by saying that *the way in which he received what it is sought to tax* prevents him from being taxed on it;
> [3] and that the Crown is in a position to reply that if he had received what it is sought to tax *in another way* he would have had to bear tax.
> In other words, there must be a contrast as regards the "receipts" between
> [a] the actual case where these accrue in a non-taxable way with
> [b] a possible accruer in a taxable way,
> and unless this contrast exists, the existence of the advantage is not established.[16]

One must identify a hypothetical receipt to the taxpayer which would be taxable. This need not involve the same kind of transaction as the actual transaction. In *IRC v Cleary*[17] the shareholder sold an asset to a company. The actual receipt was not taxable. This was compared to a hypothetical but possible dividend from the company which would have been taxable. So there was an "income tax advantage". The hypothetical dividend was

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15 Section 683(3) provides: "In this section 'relief from income tax' includes a tax credit".

16 43 TC 396 at p.441 (emphasis added).

17 44 TC 399 at p.423.

an entirely different kind of transaction: it reduced the company's assets (unlike the actual sale). Remarkably the House of Lords (Viscount Dilhorne) held that this made no difference. This could lead of course to double taxation on the payment of an actual dividend later. So in short, the question has been whether the company can pay a dividend to the person in question equal to the amount received tax-free.

A loan to a 100% shareholder in principle confers an income tax advantage as the sum loaned could have been received as a dividend.[18]

The same applies if a company lends a sum to all its shareholders in proportion to their holdings.

What if a company makes a loan only to (say) a 50% shareholder? It is considered that there is no "income tax advantage" because the company would have had to declare a dividend of twice the sum loaned. But it is suggested that there is an income tax advantage if it is realistic to contemplate other shareholders waiving their entitlement to a dividend or transferring it to him.

What if the loan is to a remittance basis taxpayer? If the sum loaned is retained offshore, there is no income tax advantage. For a hypothetical dividend retained offshore would also not be taxable. There is no "possible accruer in a taxable way".[19] But if the sum loaned is remitted there is an income tax advantage.

30.10 The circumstances

There are five sets of circumstances set out in the legislation, but the only one relevant is Circumstance D, which is the widest. Section 689 ITA provides:

> **Receipt of consideration in connection with relevant company distribution (circumstance D)**
> (1) This section applies in relation to a person if subsections (2) to (4) apply.

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18 *Williams v IRC* 54 TC 257 at p.308. This assumes that the company has assets available for distribution.

19 Actually there *is* a possible accruer in a taxable way; a dividend received in the UK would be taxable. But that does not count. Otherwise a foreign domiciliary enjoys a tax advantage whenever he receives foreign income and choses not to remit it; which is absurd. There must be some limits to the approach in *Cleary* that we need not compare like with like.

(2) The person receives consideration[20] in connection with—
(a) the distribution, transfer or realisation of assets of a relevant company (see section 691), or
(b) the application of such assets in discharge of liabilities.

The person must be the person who obtained the tax advantage.

Section 689(3) ITA requires that:

The consideration
(a) is or represents the value of—
(i) assets which are available for distribution by way of dividend by the company, or
(ii) assets which would have been so available apart from anything done by the company,
(b) is received in respect of future receipts of the company, or
(c) is or represents the value of trading stock of the company.

This is here called "**distributable consideration**".[21]

Section 689(4) ITA requires that:

The person so receives the consideration that the person does not pay or bear income tax on it (apart from this Chapter).

I refer to this as receipt of a "**non-taxable sum**".

"Relevant company" is defined in s.691 ITA:

(1) A company is a relevant company for the purposes of sections 689 and 690 if it is—

20 s.689(6) ITA provides:
"In this section references to the receipt of consideration include references to the receipt of any money or money's worth."

21 s.689(5) ITA restricts this concept:
"The assets mentioned in subsection (3) do not include assets which are shown to represent a return of sums paid by subscribers on the issue of securities, despite the fact that under the law of the country in which the company is incorporated assets of that description are available for distribution by way of dividend."
But this will not usually apply where there is a loan.

(a) a company under the control[22] of not more than 5 persons (but see subsection (2)), or
(b) any other company none of whose shares or stocks[23] is—
(i) listed in the Official List of the Stock Exchange, and
(ii) dealt in on the Stock Exchange regularly or from time to time.
(2) A company is not a relevant company for those purposes if it is under the control of one or more companies which are not relevant companies for those purposes.

In practice, the company making the loan will normally be a relevant company.

The person need not receive the consideration directly from the company.[24]

30.11 "In consequence of a transaction in securities"

Is the loan "in consequence of a transaction in securities"? This must depend on the circumstances. The first step is to identify the transaction in securities.

30.12 The escape clause

Section 685 ITA provides:

Exception where no tax avoidance object shown
(1) Section 684 does not apply to a person in respect of a transaction in securities or two or more such transactions if the person shows that the transaction or transactions meet conditions A and B.
(2) Condition A is that the transaction or transactions are effected—
(a) for genuine commercial reasons,[25] or
(b) in the ordinary course of making or managing investments.
(3) Condition B is that enabling income tax advantages to be obtained

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22 s.691(4) ITA provides: "In this section 'control' has the meaning given by section 416(2) to (6) of ICTA (close companies: meaning of 'associated company' and 'control')."

23 s.691(3) ITA provides: "The reference in subsection (1)(b) to shares or stocks does not include debenture stock, preferred shares or preferred stock."

24 This is self-evident but if authority is needed see *IRC v Wiggins* 53 TC 639.

25 On the meaning of "genuine commercial" see 21.5 ("Commercial" in old Condition B).

is not the main object or one of the main objects of the transaction or, as the case may be, any of the transactions.

This is known as the escape clause.

"The transaction(s)" means the transactions in securities. The transactions must satisfy both Conditions A and B.

30.13 Discussion

30.13.1 *Loan to individual 100% shareholder*

Suppose a company is wholly owned by a UK resident individual ("B"), and the company lends interest free to B.

B obtains an income tax advantage. The company is likely to be a relevant company.

Is Circumstance D satisfied? B receives a non-taxable sum. There is a transfer of assets (the loan). However, does B receive the sum "in connection" with a transfer of assets? If the company already had the cash, then the only "transfer of assets" is the loan itself. Is the loan connected with itself? The answer must be, no. If the company had to sell assets in order to raise cash to make the loan, that sale would be a "transfer of assets" and Circumstance D would be satisfied.

None of this matters unless there is a transaction in securities. The loan is not itself a transaction in securities.

If the company had to sell securities in order to raise funds to make the loan, then the loan may be said to be in consequence of that sale. If the company already possessed the cash, or acquired it without a transaction in securities, then s.684 does not apply.

Even if there is a transaction in securities, the escape clause may apply if the transaction is for commercial reasons.

30.13.2 *Loan to discretionary trust*

Suppose the company is held by a non-resident discretionary trust, and lends interest free to the trustees. The trustees do not obtain an income tax advantage. The trustees would not have been taxable on a dividend.

Suppose the trust is settlor-interested. If the settlor ("S") is UK resident and domiciled S obtains an income tax advantage. (What if S was not UK domiciled? There is no IT advantage unless the proceeds are received in the UK.)

However, S does not receive distributable consideration so Circumstance D is not satisfied even if S does obtain an income tax advantage.

30.14 Schedule 4B TCGA 1992

A loan from a company to a trust constitutes "trustee borrowing" for the purposes of Schedule 4B TCGA. RI 259 shows that HMRC take this unmeritorious point:

> It is not unusual for the trustees of a non-resident trust to borrow money from a non-resident company which they control. In this situation, if the company were resident in the UK, TA 1988 s 419 might well be applicable. It has been suggested that in this situation the trustees are effectively "borrowing" from themselves and therefore outside para 4(1). We consider this incorrect, particularly in the light of *Chamberlain v IRC*, 25 TC 357. It does not matter whether the borrowing is from a company controlled by the trustees or their associates, or from an entirely unconnected company. What matters is the use to which the borrowing is put.

Sympathetic courts have allowed trustees to avoid the unfairness by setting aside loans made by trustees in (understandable) ignorance of these daft rules.[26]

A full discussion of Schedule 4B needs to a book to itself, and is not attempted here.

26 *Re Leumi Overseas Trust* [2007] JRC 248; *Barclays Private Bank v Chamberlain* 9 ITELR 304.

CHAPTER THIRTY ONE

NON-RESIDENTS INCOME TAX RELIEF

31.1 Limit on liability for non-residents – Introduction

This chapter considers the IT relief for UK source income of non-residents. The legislation is twice as long as it needs to be as it distinguishes unnecessarily between:

(1) non-resident individuals and trustees
(2) non-resident companies

The two reliefs are fundamentally the same. I refer to them together as **"non-residents IT relief"**.

31.2 Relief for non-resident individuals and trustees

In the absence of relief, non-resident individuals and trustees are subject to tax on UK source income at the same rates as UK residents. Thus non-resident individuals are subject to income tax at the higher rate, and non-resident trustees are subject to tax at the trust rate. Section 811 ITA provides relief. Section 811(1) ITA provides:

> This section applies to income tax to which—
> (a) a non-UK resident, other than a company, is liable, or
> (b) a non-UK resident company is liable as a trustee.[1]

Section 811(3) ITA sets out the relief:

> The non-UK resident's liability to income tax for a tax year is limited

1 Section 811(1)(b) is otiose since a trustee is a separate person for tax.

to the sum of amounts A and B.

There is no equivalent CGT relief but that is not needed as a non-resident is not usually subject to CGT. As the ITH states in para 970:

> it would be very rare to find a situation where a non-resident would be liable on capital gains made through an investment manager.

An individual must be non-resident throughout the year: the split year concession does not apply.[2]

31.3 Amount A

Section 811(4) ITA defines amount A:

> Amount A is the sum of—
> (a) any sums representing income tax deducted from the non-UK resident's disregarded income for the tax year (see section 813),
> (b) any sums representing income tax that are treated as deducted from or paid in respect of that income, and
> (c) any tax credits in respect of that income.

In short, amount A is tax deducted at source or its equivalent.

31.4 Amount B

Section 811(5) ITA defines amount B:

> Amount B is the amount that, apart from this section, would be the non-UK resident's liability to income tax for the tax year, if the following were left out of account—
> (a) the non-UK resident's disregarded income for the tax year, and
> (b) any relief mentioned in subsection (6) to which the non-UK resident is entitled for the tax year as a result of—
> (i)section 56(3) or 460(3) of this Act or section 278(2) of ICTA (residence etc of claimants), or
> (ii) double taxation arrangements.

2 See 6.11 (Non-residents income tax relief).

I refer to the reliefs within (b) as "**disregarded reliefs**". These reliefs are not disapplied. The individual can claim them if he wants. But that increases amount B, so reduces the benefit of s.811 relief. A higher rate taxpayer will often be no better off, particularly after taking professional costs into account. The policy of non-resident IT relief is "You don't bother us (by claiming reliefs) and we won't bother you (by seeking higher rate tax)".[3] In short, one disregards "disregarded income" but loses the benefit of DTT relief, personal allowances and other minor reliefs.

Section 811(6) ITA sets out the full list of disregarded reliefs:

> (6) The reliefs referred to in subsection (5) are—
> (a) an allowance under Chapter 2 of Part 3 of this Act or section 257 or 265 of ICTA (personal allowance and blind person's allowance),
> (b) a tax reduction under Chapter 3 of Part 3 of this Act or section 257A, 257AB, 257BA or 257BB of ICTA (tax reductions for married couples and civil partners),
> (c) relief under section 457 or 458 of this Act (payments to trade unions and police organisations),
> (d) a tax reduction under section 459 of this Act or section 273 of ICTA (payments for benefit of family members), and
> (e) relief under section 266 of ICTA (life assurance premiums).

31.5 Further condition for trusts

Section 812(1) ITA provides:

> Section 811 does not apply to income tax to which non-UK resident trustees are liable for a tax year, if there is a beneficiary of the trust who is—
> (a) an individual who is ordinarily UK resident, or
> (b) a UK resident company.

One UK beneficiary may disqualify the entire trust from the relief.

31.5.1 "*Beneficiary*"

Section 812 ITA then defines "beneficiary":

3 I am grateful to Robert Venables QC for this observation.

> (2) For the purposes of subsection (1) a person is a beneficiary of the trust if—
> (a) the person is an actual or potential beneficiary of the trust, and
> (b) condition A or B is met in relation to the person.
> (3) Condition A is that the person is, or will or may become, entitled under the trust to receive some or all of any income[4] under the trust.
> (4) Condition B is that some or all of any income under the trust may be paid to or used for the benefit of the person in the exercise of a discretion conferred by the trust.

The definition is the same as 29.9.5 (Non-resident trusts).

31.6 Disregarded income

The definition of "disregarded income" is crucial. There are six categories of disregarded income. Section 813(1) ITA provides:

> For the purposes of this Chapter income arising to a non-UK resident is "disregarded income" if it is—
> (a) disregarded savings and investment income (see section 825),
> (b) disregarded annual payments (see section 826),
> (c) disregarded pension income,
> (d) disregarded social security income,
> (e) disregarded transaction income (see section 814), or
> (f) income of such other description as the Treasury may by regulations designate for the purposes of this section.

Thus we have to turn to another five definitions. But first, s.813(2) ITA brings in an important exception:

> But income in relation to which the non-UK resident has a UK representative for the purposes of section 126 of, and Schedule 23 to, FA 1995 (UK representatives of non-UK residents) is not disregarded income.

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4 Income is in turn defined in s. 812(5) ITA:
"The references in subsections (3) and (4) to any income under the trust include a reference to any capital under the trust so far as it represents amounts originally received by the trustees as income."

31.7 Disregarded savings and investment income

Section 825 ITA provides the definition:

(1) For the purposes of this Chapter income is "disregarded savings and investment income" if—
(a) it is chargeable under Chapter 3 or 5 of Part 4 of ITTOIA 2005 (dividends etc from UK resident companies and stock dividends from UK resident companies), or
(b) it is within subsection (2) and is not relevant foreign income.
(2) Income is within this subsection if it is chargeable under—
(a) Chapter 2 of Part 4 of ITTOIA 2005 (interest),
(b) Chapter 7 of that Part (purchased life annuity payments),
(c) Chapter 8 of that Part (profits from deeply discounted securities),
(d) Chapter 10 of that Part (distributions from unauthorised unit trusts), or
(e) Chapter 11 of that Part (transactions in deposits).

31.8 Disregarded annual payments

Section 826 ITA provides the definition:

For the purposes of this Chapter income is "disregarded annual payments" if it is not relevant foreign income and is chargeable under—
(a) section 579 of ITTOIA 2005, so far as it relates to annual payments (royalties etc from intellectual property),
(b) Chapter 4 of Part 5 of that Act, so far as it relates to annual payments (certain telecommunication rights: non-trading income), or
(c) Chapter 7 of Part 5 of that Act (annual payments not otherwise charged).

31.9 Disregarded pension/social security income

Section 813 ITA provides:

(3) Income is "disregarded pension income" if it is chargeable under Part 9 of ITEPA 2003 (pension income) because any of the following provisions of that Act applies to it—
section 577 (UK social security pensions),
section 579A (pensions under registered pension schemes) (but see

subsection (4) below),
section 609 (annuities for the benefit of dependants),
section 610 (annuities under non-registered occupational pension schemes), or
section 611 (annuities in recognition of another's services).[5]

(5) Income is "disregarded social security income" if—
(a) it is a taxable benefit listed in Table A in section 660 of ITEPA 2003, other than income support or jobseeker's allowance, and
(b) it is chargeable under Part 10 of that Act (social security income).

31.10 Limit on liability: companies

31.10.1 *Income tax limit*

Non-resident companies are in principle subject to income tax on UK source income at the basic rate. Section 815 ITA provides relief:

> (1) This section applies to income tax to which a non-UK resident company is liable, otherwise than as a trustee.
> (2) The non-UK resident company's liability to income tax for a tax year is limited to the sum of amounts A and B.
> (3) Amount A is the sum of—
> (a) any amounts representing income tax deducted from the non-UK resident company's disregarded company income for the tax year,
> (b) any amounts representing income tax that are treated as deducted from or paid in respect of that income, and
> (c) any tax credits in respect of that income.
> (4) Amount B is the amount that, apart from this section, would be the non-UK resident company's liability to income tax for the tax year if the non-UK resident company's disregarded company income for the tax year were left out of account.

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5 Section 813(4) ITA provides:
"Income chargeable under Part 9 of ITEPA 2003 because section 579A of that Act applies to it is disregarded pension income only if the registered pension scheme in question—
(a) falls within para 1(1)(f) of Schedule 36 to FA 2004, and
(b) was, immediately before 6 April 2006, a retirement annuity contract to which section 605 of ITEPA 2003 applied."

31.10.2 *Disregarded company income*

There are five categories of disregarded company income. Section 816 ITA provides:

> (1) For the purposes of this Chapter income arising to a non-UK resident company is "disregarded company income" if it is—
> (a) disregarded savings and investment income (see section 825),
> (b) disregarded annual payments (see section 826),
> [(c) and (d) relate to the IME, see 33.1 (Investment manager exemptions - Introduction).
> (e) income of such other description as the Treasury may by regulations designate for the purposes of this section.

This is effectively the same as the definition of "disregarded income" which applies for s.811 relief (individuals and trusts). There are two apparent differences:

(1) It omits references to pension or social security income (which do not apply to companies).
(2) There are differences in the wording of s.816(1)(c)(d) which are the equivalent of the individual's exemption for "transaction income" but I cannot see they are of any significance.

CHAPTER THIRTY TWO

COLLECTION OF TAX FROM UK REPRESENTATIVES

32.1 Collection of tax directly from non-residents

The ITH provides:

903. Machinery of assessment: direct charge on non-residents
It always was and still is possible to assess a non-resident directly if, in the words of the Courts, he can be reached. A simple example of such a situation arose in the case of *Tischler v Apthorpe* [2 TC 89]. Mr Tischler was not resident. He was a partner in a French wine firm who spent four months or so a year in England. He lived then in a London hotel and sold wine to English customers. His firm also employed London agents and the question was whether the English profits could be assessed directly on Mr Tischler or whether such assessments should, Mr Tischler being non-resident, be made only on the English agents. The High Court held that an assessment made directly on the firm was good and that Mr Tischler was obliged to make a return served on him. In the words of Mathew J 'If the principal can be got at there is no need to have recourse to Section 41 (of the 1842 Act which was consolidated in Section 78 TMA 1970.)
An individual, clearly, can be physically present in this country without being resident here and we used to have to rely on the principle established by the Tischler case in reaching the profits made by overseas sportsmen and women and artistes who come to this country for quite brief engagements. The modern view certainly, is that a non-resident company which trades here equally is here and that it may similarly be reached. If the company has a branch presence here with all the physical trappings of its trade it is visibly here and will have a registered place of business, an address at which it may be found and at which legal notices may be served.
The principle of direct assessment is not confined to non-residents who actually come here. There is no bar on direct assessment of non-residents who are not here whether or not they have agents in the UK. This was made clear in the case of *Werle v Colquhoun* [2 TC 412]. The difficulty with direct assessment on a person who is not here lies in recovering the tax, although now that the Supreme Court rules allow service of writs abroad this may be a little easier provided there are assets in the UK. But it is still true to say that if a non-resident company

> acting through an agent has no such physical presence here and has nothing here the Revenue cannot, in practice, impose its charge effectively without more adequate machinery including that for the service of notices and returns as well as for the actual gathering of the tax. It was in such situations – where the non-resident had only an agent here – that the original form of Part VIII was intended to come to the Revenue's aid. In practice Part VIII is normally used today even in those cases where the taxpayer can be reached directly ...

This was written before the 1995 changes and before the mutual collection of tax agreements but the point is still valid.

32.2 Collection of tax from UK representative

Section 126(1) FA 1995 provides:

> Schedule 23 to this Act shall have effect for imposing obligations and liabilities in relation to income tax and capital gains tax on a branch or agency which, under this section, is the UK representative of a person who is not resident in the UK ("the non-resident").

In the following discussion "**the non-resident principal**" is the person for whom the UK representative is a representative (who the statute calls "the non-resident".)

So we turn as directed to para 1 Sch 23 FA 1995 which provides:

> **General imposition of obligations etc**
> (1) Subject to the following provisions of this Schedule, the provisions of the Tax Acts, of the Taxation of Chargeable Gains Act 1992 and of any subordinate legislation[1] made under the Tax Acts or that Act of 1992, so far as they—
> (a) make provision for or in connection with the assessment, collection and recovery of tax, or of interest on any tax, and
> (b) apply in any case for purposes connected with the taxation of any amounts in relation to which the non-resident has a UK representative,
>
> shall have effect in that case with respect to tax chargeable on, and interest payable by, the non-resident as if the obligations and liabilities of the non-resident by virtue of those provisions were also obligations

1 Para 1(2) unnecessarily provides the definition: "In this paragraph "subordinate legislation" has the same meaning as in the Interpretation Act 1978."

and liabilities of the UK representative.

This is a collection provision (the metaphor often used is "machinery provision") and not a charging provision: the UK representative is only subject to tax if there is a charge to tax on usual principles on the non-resident principal. The INTM para 268010 [November 2004] provides:

> The machinery provisions alone cannot create or extend a tax liability on the non-resident. There has to be a charge to tax in respect of the non-resident under the domestic provisions in the first place. The provisions work by treating the tax obligations and liabilities of the non-resident as though they were additionally the obligations and liabilities of the UK representative. This provides a practical assessment and collection mechanism for non-residents. Once either the non-resident or the UK representative has paid the liabilities both parties are treated as having met their liabilities.

32.3 "UK representative"

The definition of "UK representative" is clearly central. Section 126(2) FA 1995 gives the basic definition:

> Subject to the following provisions of this section and to section 127 below, a branch or agency[2] in the UK through which the non-resident carries on (whether solely or in partnership) any trade, profession or vocation shall, for the purposes of this section and Schedule 23 to this Act, be the non-resident's UK representative ...

Thus a UK representative is in short a branch or agency.

The question whether the non-resident principal is trading is crucial for the UK representative rules because these rules only apply if the non-resident principal is carrying on a trade, profession or vocation.[3]

32.4 Amount for which UK representative is liable

Section 126(2) FA 1996 goes on to define the amounts in which a UK

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2 Section 126(8) FA 1995 defines "branch or agency" in the traditional way; see 64.11 (Meaning of "branch or agency").

3 See 33.2.1 (When is there a trade in financial assets?)

representative is concerned:

> ... in relation to the following amounts, that is to say—
> (a) the amount of any such income from the trade, profession or vocation as arises, directly or indirectly, through or from that branch or agency;
> (b) the amount of any income from property or rights which are used by, or held by or for, that branch or agency; and
> (c) amounts which, by reference to that branch or agency, are chargeable to capital gains tax under section 10 of the Taxation of Chargeable Gains Act 1992 (non-residents).[4]

The INTM para 268030 provides:

> A person can only be the UK representative in respect of the permanent establishment/branch or agency with which they are linked. Where a non-resident has more than one UK permanent establishment/branch or agency, then it is possible that each will have a different UK representative. In those circumstances, each UK representative would only be responsible in respect of the part of their non-resident's liabilities and obligations arising from their own permanent establishment/branch or agency [*Neilsen Andersen & Co v Collins,* and *Tarn v Scanlan* 13 TC 91].

The ITH explains "directly or indirectly" in s.162(2)(a):

> **914. General**
> Section 79 [TMA 1970] is another 1915 amendment. It provides that a non-resident shall be chargeable on profits or gains arising directly or indirectly through any branch, agency etc here. The sort of thing that was happening, before this provision was introduced, was that an agent for a non-resident would negotiate a contract here and at the end of the oral negotiations the agent and the third party would agree to sign the formal documents abroad. The view the Revenue took, and defensibly so, was that in substance all had been done here apart from signing a piece of paper and that it was wrong for liability so to be avoided.
> Problems of that sort are really problems of fact and proof as was mentioned in chapter 8 (ITH822). If the Revenue could have proved that there was an unwritten agreement made in London, it would have

4 See 64.10 (Why does branch/agency matter?).

succeeded in a claim that the non-resident was trading here, and that is what we would argue today. Millions of pounds worth of business are done in the City of London every day on the basis of spoken agreements which are later confirmed in writing and nobody wishes to deny that the word is the contract. But, when the parties to the contract do not wish to act openly, proof is difficult to come by. What these words were meant to do was to enable the Revenue to say – "we must accept that this contract was made abroad because we cannot prove otherwise but a lot of negotiation took place in London and we want to look at the substance of the matter and the words 'directly or indirectly' will enable us to do that".

32.5 Agents not treated as UK representatives

Section 127(1) FA 1995 provides three exceptions which I call:

(1) "**the casual agent exemption**";
(2) "**the broker exemption**";
(3) "**the investment manager exemption**".

I consider the first of these here; for the IME and broker exemptions, see 33.1 (Investment manager exemptions)

32.6 Casual agent exemption

Section 127(1) FA 1995 provides:

> For the purposes of section 126 above and Schedule 23 to this Act, none of the following persons shall be capable of being the non-resident's UK representative in relation to income or other amounts falling within paras (a) to (c) of section 126(2) above, that is to say—
> (a) where the income arises from, or the other amounts are chargeable by reference to, so much of any business as relates to transactions carried out through a person who (though an agent of the non-resident) does not act in relation to the transactions in the course of carrying on a regular agency for the non-resident, that agent;

The INTM para 268020 [March 2007] provides:

> Section 127(1) FA 1995 lists the persons who cannot be the UK representative for income tax and capital gains tax:

i) Agents who are not regular agents. In general if a non-resident is trading in the UK through an agent that agent should be regarded as a regular agent. This was considered in the cases of *Neilsen Andersen & Co v Collins* and *Tarn v Scanlan* (13 TC 121–2) when Scrutton LJ considered "the contrast intended to be drawn is between casual employment, temporary employment, for a transaction or few transactions, and regular appointment of a permanent agent who is there as representing the foreigner".

The ITH provides:

> **942. NRs: accepting TMA 70 s.82 exemption: regular agency**
> ... casual agents are protected from assessment. As a general rule if there is UK source income and there is an agent we would want to assess the agent. A non-resident trading here through an agent will usually clearly do so through a regular agency.
> It may be less clear whether an agent is a regular agent when he acts for his principal in only one transaction. This was the issue in the case of *Willson v Hooker* 67 TC 585. Acting for an Isle of Man company, Mr Willson instructed a firm of surveyors to bid for some land in the UK and instructed solicitors concerning the purchase and sale of the land. The Court said that a regular agency is any agency that is not a casual or occasional agency and that it was impossible to regard Mr Willson as a casual or occasional agent. He was the person through whom all the transactions of the company in the UK were carried out in the relevant period and so did not enjoy protection.

32.7 Subsidiary points

32.7.1 *HMRC procedures*

The INTM para 268040 provides:

> **What assessments should be raised and how is that done?** [March 2007]
> As already explained above (INTM268030)) both the non-resident and their UK representative have a personal responsibility for the tax obligations and liabilities arising from the UK permanent establishment/branch or agency. Either party is able to discharge those obligations and liabilities. So we can assess either or both parties if necessary. Once one party has paid the personal responsibility on the other party lapses for that self assessment period. Obviously in cases where self assessments are returned by or for a non-resident taxpayer and tax payments are made at the appropriate times no further action would be needed. This guidance concerns the practicalities of how to handle cases where obligations and liabilities

are not met.

Because the UK representative is personally responsible for the non-residents tax obligations and liabilities, a unique tax reference should be allocated to the UK representative in that capacity. Where the UK representative is an agent (rather than a branch or fixed place of business permanent establishment) that unique tax reference should be a distinct and different reference to the one allocated to the agent for their own business. Non-resident companies intending to set up places of business in the UK are obliged to notify Companies House (see **Self assessment** at INTM261000). The consequential process in place automatically generates tax references and allocates them to the office responsible for the UK registered office address. Where that process has not happened, or for non-corporates, a taxpayer record with unique tax reference will need to be created on notification or discovery of liability.

The High Court held in the case of *Tischler v Apthorpe* [2 TC 89] that a non-resident could be assessed directly "wherever he could be reached" including the UK branch address. The decision in that case was that an assessment raised directly on the non-resident at the UK branch address was valid, even though there was also a UK representative who could have been assessed under the machinery provisions (the TMA 1970 version *see* INTM268010). It is probably unusual for a non-resident to have both a physical UK branch and an appointed UK agent but the reasoning in that case supports the equal validity of assessments made on the non-resident either directly at their UK branch or at the overseas address. In that case, of course, the UK agent could not be responsible for the tax assessed as he had not been notified.

So, on a practical level, assessments should be addressed in the manner most suited to the facts of the case and with the object of informing the relevant persons of the liability and securing the necessary payment of tax. Depending upon how near to expiry the assessing time limits are this could include any but possibly all of the following:

Assessment for a branch or fixed place of business in the UK
Assessment for UK trade carried out through an agent
Partners and partnerships
Recovery action

Assessment for a branch or fixed place of business in the UK

- Assess in the name of the non-resident individual or company at the UK business address.
- Send a copy also, for information, to the non-resident's address abroad if known.
- Assess any person who clearly has the capacity of "UK representative" e.g. the manager of the UK operations, as "Mr X as UK representative of XYZ".

Assessment for UK trade carried out through an agent

- Assess in the form "Mr X as agent for XYZ" sent to the agent's address.
- Send a copy of the assessment on the agent, for information, to the non-resident at their address abroad if known.
- Assess the non-resident individual or company at their address abroad if known.

Partners and partnerships
Where the UK representative is a UK partnership the partnership itself is the UK representative. In such circumstances the partners in the UK partnership will be jointly liable for the tax payable by the non-resident. It follows that any assessment that is required should be made on the partnership as agent for the non-resident. Where a non-resident is a partner in a partnership which trades in the UK directly, typically through a UK branch or fixed place of business, the form of assessment depends on whether there is a partner resident in the UK. If there is a UK resident partner the assessment should be made on the partnership as a whole but the UK resident partner will be jointly liable for the tax payable by the entire partnership. Where there is no UK resident partner then assessments on the branch profits of the non-resident partners should be made on the UK branch of the partnership.

32.7.2 *Representative ceasing to act*

Section 126(3) FA 1995 provides for the representative ceasing to act:

> For the purposes of this section and Schedule 23 to this Act, the non-resident's UK representative in relation to any amount shall continue to be the non-resident's UK representative in relation to that amount even after ceasing to be a branch or agency through which the non-resident carries on the trade, profession or vocation in question.

The INTM para 268040 provides:

> Where the trading activities in the UK have ceased the UK permanent establishment/branch or agency retains the obligations and liabilities as the UK representative even after the cessation. This provision is at Section 126(3) FA 1995 for income tax and at Section 150(2)(c) FA 2003 for corporation tax. So assessments can still be raised on the UK representative subject to the usual assessing time limits. Where however the trading was conducted through a branch or fixed place of business and that presence has discontinued there may be difficulties identifying any person as the UK representative or any assets within the UK upon which recovery may rely. It is therefore recommended that assessments for such UK branches are raised and tax brought into charge at as early a stage as possible.
> Additionally, by EU Directive member states of the European Union are able to seek the assistance of another member state in the recovery of direct and indirect taxes (see the recovery guidance at REC1139).

32.7.3 *Separate personality*

Section 126(4) FA 1995 provides for deemed separate personality:

> For the purposes of this section and Schedule 23 to this Act, the non-resident's UK representative in relation to any amount shall be treated, where he would not otherwise be so treated, as if he were a separate and distinct person from the non-resident.

The AP Manual para 165 explains the reason:

> Where an assessment is required on a UK agent the normal practice will be to send it to the agent in the form "X as agent for Y". An assessment on a UK branch should normally be sent to the branch address. In order to allow service of notices and collection to take place at the branch, the branch business is treated for this purpose as a separate person.[5]

32.7.4 *Partnerships*

Section 126(5) FA 1995 deals with a UK representative which is a partnership:

> Where the branch or agency through which the non-resident carries on the trade, profession or vocation is one carried on by persons in partnership, the partnership, as such, shall be deemed for the purposes of this section and Schedule 23 to this Act to be the non-resident's UK representative in relation to the amounts mentioned in subsection (2) above.

Section 126(6), (7), (7A) FA 1995 deals with non-resident trading partnerships:

> (6) Where a trade or profession carried on by the non-resident through a branch or agency in the UK is one carried on by him in partnership, the trade or profession carried on through that branch or agency shall be deemed, for the purposes of this section and Schedule 23 to this Act, to include the notional or deemed trade or profession.
> (7) For the purposes of this section and Schedule 23 to this Act where—

5 The IT Self Assessment Manual makes the same point at 7.30.

(a) a trade or profession carried on by the non-resident in the UK is one carried on by him in partnership, and
(b) any member of that partnership is resident in the UK,
the notional or deemed trade or profession shall be treated (in addition, where subsection (6) above also applies, to being treated as included in a trade or profession carried on through any such branch or agency as is mentioned in that subsection) as a trade carried on in the UK through the partnership as such.
(7A) In subsections (6) and (7) "the notional or deemed trade or profession" means—
(a) the notional trade from which the non-resident's share in the partnership's profits or losses is treated for the purposes of section 852 of the Income Tax (Trading and Other Income) Act 2005 as deriving, or
(b) he deemed trade or profession from which that share is treated for the purposes of section 114 of the Taxes Act as deriving.

The INTM para 268020 [March 2007] provides:

Partnerships can be the UK representative of a non-resident
A partner in a partnership can be the UK representative of a non-resident. This will occur, for example, where a non-resident trades in the UK though the agency of a UK partnership (of which he or she is not a member). In such circumstances, the partners in the UK partnership will be jointly liable, as UK representative, for the tax payable by the non-resident. This provision is at Section 126(5) FA 1995 for income tax and is implicit in Section 150 FA 2003 for corporation tax.
Where a business that is carried on by a partnership that includes non-resident partners is carried on in the UK through a permanent establishment/branch or agency, the permanent establishment/branch or agency is the UK representative of each non-resident partner. This provision is at Section 126(6) FA 1995 for income tax and is implicit in Section 150(2) FA 2003 for corporation tax.
Where a business is carried on in the UK by a partnership that includes both resident and non-resident partners, the partnership is treated as the UK representative of each non-resident partner. The partners are thus jointly liable for the tax payable by the non-resident partners on their shares of the partnership profit. This provision is at Section 126(7) FA 1995 for income tax and is implicit in Section 150 ICTA 1988 for corporation tax.

The IT Self Assessment Manual provides:

A partnership can be the UK representative of a non-resident

7.31 A partner in a partnership can be the UK representative of a non-resident. This will occur, for example, where a non-resident trades in the UK though the agency of a UK partnership (of which he or she is not a member). In such circumstances, the partners in the UK partnership will be jointly liable, as UK representative, for the tax payable by the non-resident.

Partnership, which includes non-resident partners, trading in the UK through a branch or agency/permanent establishment: the branch or agency/permanent establishment is treated as the UK representative of non-resident partners

7.32 Where a business that is carried on by a partnership that includes non-resident partners is carried on in the UK through a branch or agency/permanent establishment, the branch or agency/permanent establishment is treated as the UK representative of each non-resident partner.

Partnership trading in the UK which includes resident and non-resident members is treated as UK representative of non-resident partners

7.33 Where a business is carried on in the UK by a partnership which includes both resident and non-resident partners, the partnership is treated as the UK representative of each non-resident partner. The partners are thus jointly liable for the tax payable by the non-resident partners on their shares of the partnership profit.[6]

32.8 Discharge of obligations and liabilities

Schedule 23 FA 1995 provides:

2 Discharge of obligations and liabilities

Subject to the following provisions of this Schedule—

(a) the discharge by the non-resident's UK representative or by the non-resident himself of an obligation or liability which is or corresponds to one to which that representative is subject under this Schedule shall be treated as discharging the corresponding obligation or liability to which the other is subject; and

(b) the non-resident shall be bound, as if they were his own, by any acts or omissions of his UK representative in the discharge of the obligations and liabilities imposed on that representative by this Schedule.

6 The same point is made in AP Manual paras 169–170.

The IT Self Assessment Manual provides:

> 7.17 The general rule is that UK representatives are jointly responsible with the non-resident for all the tax obligations and liabilities in relation to the trade, profession or vocation carried on through the branch or agency/permanent establishment.
> 7.18 This joint responsibility extends to all matters relating to the assessment of tax and to the collection and recovery of tax. For example, it extends to all the mechanisms of Self Assessment, including notification of chargeability, the obligation to make a tax return and self assessment, liability to make interim and final payments of tax, and liability to surcharges, interest and penalties in connection with those obligations and liabilities.
> 7.19 Either party is able to discharge the obligations and liabilities arising, but equally any acts or omissions of the non-resident are treated as acts or omissions of the UK representative (but see also Paras 7.25 to 7.26 in relation to tax offences).
> 7.20 Where the trigger for an obligation or liability is the receipt of formal notification, then the obligation or liability only falls on the UK representative once they have received the relevant notification (or a copy).[7]

Schedule 23 FA 1995 continues:

> **3 Obligations and liabilities requiring notice**
> Where any obligation or liability such as is mentioned in para 2 above arises only if the person on whom it is imposed has been given or served with a notice or other document or has received a request or demand, that obligation or liability shall not by virtue of this Schedule be treated as having been imposed on the non-resident's UK representative unless the notice or document, or a copy of it, was given to or served on that representative, or he was notified of the request or demand.

32.9 Information requirements

Para 4 Sch 23 FA 1995 provides:

> (1) The obligations relating to the furnishing of information which are

7 The same point is made in the AP Manual para 165.

imposed by this Schedule on the non-resident's UK representative in a case where that representative is his independent agent shall not require that representative to do anything except so far as it is practicable for the representative to do so by acting to the best of his knowledge and belief after having taken all reasonable steps to obtain the necessary information.

(2) Para 2 above shall not have the effect—

(a) of discharging the non-resident from any obligation to furnish information in a case where that obligation has been discharged by his UK representative by virtue only of sub-para (1) above; or

(b) of requiring the non-resident to be bound by any error or mistake contained, otherwise than as a result of—

(i)any act or omission of the non-resident himself, or

(ii) any act or omission to which he consented or in which he connived,

in information furnished by his UK representative in compliance, so far as required by sub-para (1) above, with any obligation imposed by virtue of this Schedule on that representative.

(3) In this paragraph "information" includes anything contained in any return, self-assessment, account, statement or report that is required to be provided to the Board or any officer of the Board, and references to furnishing information shall be construed accordingly.

The AP Manual para 166 provides:

7.21 Where the UK representative is an independent agent of the non-resident acting in the ordinary course of business, its obligations to provide information are limited to ones within its competence to act for the non-resident...

7.23 The rules recognise that, where the UK representative is an independent agent, the agent may not be able to provide complete information about the affairs of the non-resident. The agent is therefore required to provide any information requested, for example a return, to the best of its knowledge and belief after taking all reasonable steps to obtain the information. The non-resident remains responsible for completing or correcting the information where necessary.

7.24 However, the non-resident can correct any error or omission made by the UK representative provided the non-resident did not know about it or participate in it.[8]

8 The same point is made in the AP Manual para 166.

32.10 Criminal offences and penalties

Para 5 Sch 23 FA 1995 provides:

> (1) A person shall not by virtue of this Schedule be guilty of a criminal offence except where he committed the offence himself or consented to, or connived in, its commission.
> (2) An independent agent of the non-resident shall not by virtue of this Schedule be liable, in respect of any act or omission, to any civil penalty or surcharge if—
> (a) the act or omission is neither an act or omission of the agent himself nor an act or omission to which he consented or in which he connived, and
> (b) he is able to show that he will not, after being indemnified for his other liabilities by virtue of this Schedule, be able to recover the amount of the penalty or surcharge out of any such sums as are mentioned in para 6 below.

The AP Manual provides:

> **167. Offences**
> The criminal and civil liabilities of a UK representative in respect of the non-resident's tax affairs are limited in certain circumstances.
> UK representatives cannot be guilty of a criminal offence under these rules as a result of something done by the non-residents unless:
> - they committed the offence, or
> - consented to its commission, or
> - connived in its commission.,
>
> The same applies for the non-resident in relation to the acts of the UK representative.
> UK representatives who are independent agents are not liable to civil penalties and surcharges unless:
> - they committed an act or omission or consented to, or connived in, its commission, or
> - they will be able to recover the penalty out of monies of the non-resident.[9]

9 The same point is made in the IT Self Assessment Manual para 7.25–7.27.

32.11 Indemnities

Para 6 Sch 23 FA 1995 provides:

An independent agent of the non-resident shall be entitled—
(a) to be indemnified in respect of the amount of any liability of the non-resident which is discharged by that agent by virtue of para 2 above; and
(b) to retain, out of any sums otherwise due from that agent to the non-resident, or received by that agent on behalf of the non-resident, amounts sufficient for meeting any liabilities by virtue of that paragraph which have been discharged by the agent, or to which he is subject.

The AP Manual provides:

168. Agents – retention of funds
UK representatives who are independent agents of non-residents are entitled to retain out of the non-resident's monies amounts sufficient to meek UK tax liabilities. No such specific provision is necessary for an agent who is not independent. Of course a branch can never be independent of the entity of what is a branch.

32.12 Meaning of "independent agent"

Para 7 Sch 23 FA 1995 provides:

(1) In this Schedule "independent agent", in relation to the non-resident, means any person who is the non-resident's UK representative in respect of any agency from the non-resident in which he was acting on the non-resident's behalf in an independent capacity.
(2) For the purposes of this paragraph a person shall not be regarded as acting in an independent capacity on behalf of the non-resident unless, having regard to its legal, financial and commercial characteristics, the relationship between them is a relationship between persons carrying on independent businesses that deal with each other at arm's length.

The IT Self Assessment Manual provides:

7.22 "Independent agent" is defined at Para 7 Schedule 23 FA 1995. The definition is based on that used in the OECD Model Tax Convention and

UK double taxation agreements.[10] Broadly, to be an "independent agent", the agent must be both legally and economically independent of the non-resident. As an independent agent is not within the definition of permanent establishment for corporation tax purposes such an agent could not become the UK representative of a non-resident company.

The ITH para 963 provides:

Meaning of "independent agent"
The definition of independent agent is intended to have the same meaning as in the OECD Model Tax Convention and Double Taxation Agreements between the UK and other countries except that it is not limited to agents ejusdem generis with broker or general commission agent (see chapter 8 ITH853). The relationship between the agent and the non-resident must have the legal, financial and commercial characteristics of one between persons carrying on independent businesses and dealing with each other at arm's length.
There is guidance in the commentary to Article 5 of the OECD Model and in cases of doubt the advice of International Division (Agency) should be sought.

10 See 64.5 (Independent agent).

CHAPTER THIRTY THREE

INVESTMENT MANAGER EXEMPTIONS

33.1 Investment manager exemptions - Introduction

This chapter considers three related exemptions where investment managers or brokers act for non-resident clients. Assuming the various requirements are met the exemptions are as follows:

(1) An investment manager is not a UK representative. The main significance of this is to disapply the rules allowing the collection of tax from UK representatives of non-residents.[1] This exemption is set out in
   (a) non-resident individuals and trustees: ss.126, 127 and Schedule 23 FA 1995;
   (b) non-resident companies: Schedule 26 FA 2003.
   I refer to this as "**the IME UK representative relief".**
(2) An investment manager is not a permanent establishment.[2] The main significance of this is to disapply the rule that a company trading through a PE is subject to corporation tax. This exemption is set out in *Schedule 26 FA 2003.* ? I refer to this as **"the IME PE relief"**.
(3) UK source income generated through investment managers is one of the classes of income which qualifies for non-residents IT relief. This exemption is part of the code of non-residents IT relief set out in Chapter 1 Part 14 ITA.[3]
   I refer to this as "**IME IT relief**".

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1 See 32.1 (Collection of tax from UK representatives).
2 See 64.6 (Broker and investment manager exemptions).
3 See 31.1 Non-residents IT relief).

I refer to the exemptions together as "**the investment manager exemptions**". (References to investment managers here include brokers.) The term used in the HMRC manuals is "investment management exemption", in the singular, abbreviated to "**IME**". There are however set out in the legislation as three separate exemptions.

The rules are written out *three* times in three different places. The rules for brokers are similar to investment managers, but are set out separately each time, so there are six sets of rules. This does make a coherent exposition rather difficult. Where the rules repeat or overlap, I set out the text of IME IT relief, giving the equivalents of the other rules in the footnotes only, unless there are material differences.

HMRC views are found in SP 1/01, revised 20 July 2007. The earlier version of the SP is still relevant until 31 December 2009,[4] but it is not considered here.

SP 1/01 explains the policy considerations behind the relief:

> 1. There are two policy objectives underlying the tax treatment of UK resident investment managers and their overseas clients. These objectives are that overseas investors should not be charged to UK tax in relation to investment transactions conducted on their behalf and that any fees earned by a UK resident investment manager for services performed for the non-resident should be fully chargeable to UK tax.
> 2. The UK tax system seeks to achieve these objectives by granting what is termed the Investment Manager Exemption. The exemption enables non-residents to appoint UK-based investment managers without the risk of UK taxation and is one of the key components of the UK's continuing attraction for investment managers. HMRC is committed to maintaining this environment by improving the exemption to meet developments in the investment management industry through providing greater flexibility and better explanations for investment managers and expanding the scope of exempt activities.

4 SP 1/01 para 5 provides: "This statement replaces the original SP 1/01 with immediate effect, except to the extent that this statement requires a non-resident or its investment manager to make changes to current circumstances or contractual arrangements in order to comply with the terms of this statement, in which case the original SP 1/01 may be applied until 31 December 2009."

33.2 Relevance of financial trading to IME

The question whether the non-resident client is trading[5] is crucial for the IME. Unless the non-resident client is trading; the three IME exemptions are not needed:

(1) In the absence of a trade, there can be no UK representative and the non-resident does not need to rely on IME UK representative relief.
(2) In the absence of a trade; a non-resident company is not subject to CT even if it has a permanent establishment and so the company does not have to rely on IME PE relief.
(3) In the absence of a trade; non-residents may qualify for non-residents IT relief and do not have to rely on IME IT relief.

SP 1/01 acknowledges this:

> **Part II: Relevance of Trading**
> 14. The Investment Manager Exemption legislation has no relevance unless the non-resident is trading in the UK.
> 15. If the transactions carried out through the investment manager are part of the trade carried on by the non-resident then, unless the tests in s 127 FA 1995 or Schedule 26 FA 2003 are satisfied (see Part III) the income from that trade, including any profit from the realisation of securities, etc, is taxable. ...

33.2.1 *When is there a trade in financial assets?*

"Trade" has no easy definition and the general question of what a trade is needs a book to itself. The question discussed here is when there is a trade in relation to financial assets. The trading/non-trading distinction is here at its most illusive.

There have been two cases discussing whether companies are trading in financial assets. In each case commissioners findings of trade were upheld, though in the second case only just (the judge would not have found there was a trade). So I think we can say that is a case of a non-trade. The principles are summarised in *Cooper v C & J Clarke Ltd*:

> First, marketable securities, being income-yielding assets usually

5 References in this chapter to "trade" include professions and vocations since there is no material difference between the two.

> capable of appreciating in value, are prima facie purchased and sold by way of investment and not by way of trade. Secondly, a series of purchases and sales may sometimes, if carried out pursuant to a deliberate and organised scheme of profit-making, amount to a trade. Thirdly, it is easier to characterise a series of purchases and sales as a trade in a case where they are made by a trading entity as opposed to an individual. Fourthly, in the case of a trading entity that characterisation is more easily made where the purchases and sales are substantial in relation to its other activities, all the more so where they are of frequent occurrence and extend over a long period of time. Fifthly, it is sometimes helpful, although not decisive, to ask whether a series of sales and purchases is speculative or not. The reason why the question is sometimes helpful is that the answer may throw light in one direction or the other, but it is not decisive because according to the circumstances either a trade or a course of investment may be speculative.[6]

33.2.2 *Trading by individuals and trustees*

There have been two cases discussing whether individuals are trading in financial assets. The first is *Salt v Chamberlain* 53 TC 143 where Oliver J said:

> Where the question is whether an individual engaged in speculative dealings in securities is carrying on a trade, the prima facie presumption would be, as Pennycuick J. suggested in the Lewis Emanuel case 42 TC 369, that he is not. It is for the fact-finding tribunal to say whether the circumstances proved in evidence or admitted take the case out of the norm.

In *Salt v Chamberlain* the individual relied on the following matters to justify a conclusion of trading. There was a relatively large number of transactions, about 50 sale/purchase transaction per annum, over a four-year period. A substantial proportion of the transactions concerned options (rather than securities yielding income). One-third of purchases and sales were within the settlement period, and many others were within a short period thereafter. The purchases were financed in part by a loan secured on the shares. On these facts the General Commissioners found

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6 54 TC 670 at 676; see too *Lewis Emanuel v White* 42 TC 369.

that the taxpayer was not trading, and on appeal, the judge held that the Commissioners were entitled to reach that conclusion.

The second case is *Wannell v Rothwell* 68 TC 719. In this case there were about 60 sale/purchase transactions per annum. The assets traded were shares and commodities. Some of the money needed was borrowed. The taxpayer was aiming at quick profits and had no intention of taking possession of the commodities or (with rare exceptions) of holding shares. The Special Commissioner did not decide whether the taxpayer was trading, but the Judge found that the Special Commissioner would have been "almost bound" to reach the conclusion that the taxpayer was trading.

There are no tax cases on whether trustees are trading, but it is considered that their position is normally similar to individuals. In *Smith v Anderson* (a non-tax case discussing an early unit trust) James LJ said:

> In my opinion, nothing that is to be done under this deed by the trustees comes within the ordinary meaning of "business", any more than what is done by the trustees of a marriage settlement who have large properties vested in them, and who have very extensive powers of disposing of the investments, changing the investments, and selling them and reinvesting in other investments, according to their discretion and judgment, with or without the consent of their cestuis que trust. That is not a business. No doubt there is power ... to dispose of the investments and reinvest in some similar securities ... This appears to me to be no more than the power of varying investments which you would find in an ordinary trust deed ...

33.2.3 *HMRC views*

SP 1/01 provides some heavily qualified generalities, and a taxpayer who tries to use this guidance will find that it does not take him very far.[7] For what it is worth, the material is set out here:

> 16. Whether or not a taxpayer is trading is a question to be determined by reference to all the facts and circumstances of the particular case. This applies as much to financial transactions as to other activities.

7 There is similar (qualified) guidance in SP 3/02.

> 17. In determining the question of trading, any transactions carried out through an investment manager are to be considered in the context of the status and world-wide activities of the non-resident. It is not possible in this statement to consider every possible set of circumstances but, for example, an individual is unlikely to be regarded as trading as a result of purely speculative transactions.[8]

This is not well worded. What does it mean? The acquisition of a security is normally described as "speculative" if the purchaser stands to make or lose money depending on how the market moves in the short term.[9] In that sense most financial assets are speculative. Presumably the SP means to say that an individual is not likely to be trading *even* as a result of purely speculative transactions.

> 18. For a company, a transaction will generally be either trading or capital in nature. (This may also be the case for non-corporate collective investment vehicles whether open-ended or closed.)

I think the point is that the transaction will not give rise to "transaction income" (formerly Schedule D Case VI).

> If the main business of a non-resident company is a trade outside the financial area, or an investment holding business, the activities in the UK would normally amount to trading only if they constituted or were

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8 Likewise SP 3/02 para 8.

9 Fred Schwed Jr gives the a better explanation of this vague word in "Where are the Customers Yachts?" (1940) Chapter 8:
"Investment and speculation are said to be two different things, and the prudent man is advised to engage in the one and avoid the other. This is something like explaining to the troubled adolescent that Love and Passion are two different things. He perceives that they are different, but they don't seem quite different enough to clear up his problems.
Investment and speculation have been so often defined that a couple more faulty definitions should do no harm, the science of economics having reached a point where further confusion is impossible. Thus,
- Speculation is an effort, probably unsuccessful, to turn a little money into a lot.
- Investment is an effort, which should be successful, to prevent a lot of money from becoming a little.
If you take a thousand dollars down to Wall Street and attempt to run it up to $25,000 in the course of a year, you are speculating. If you take $25,000 down there and attempt to earn a thousand dollars a year with it (by buying twenty-five four per cent bonds) you are investing. ...

> part of a separate financial trade. But if, exceptionally, activities which are an integral part of the profit earning activities of a non-financial trade are carried out through a UK investment manager (eg hedging on the London terminal markets by a non-resident dealer in physical commodities) then that might amount to trading here. The view to be taken on a particular case will depend on all the facts of that case.
> 19. The active management of an investment portfolio of shares, bonds and money market instruments such as bills, certificates of deposit, floating rate notes and commercial paper does not constitute a trade.

The use of the term "investment" makes this tautologous. But in case that were not so the author adds:

> But every case must be considered in the light of its own facts.
> 20. HMRC view short positions as conceptually the same as long positions and synthetic positions are conceptually the same as the equivalent 'real' positions. Neither going short nor taking synthetic positions using derivatives are in themselves indicative of trading. Furthermore, synthetic positions that give exposure to part of an asset are conceptually the same as synthetic positions that give exposure to the whole of an asset. Thus a synthetic position that gives exposure only to a bond's credit risk is no more or less likely to be a trading transaction than a synthetic or real position that gives exposure to the bond's coupon, liquidity, credit and currency risks. These techniques may constitute investment in themselves or may form part of an investment activity.
> 21. Where futures and options are used by non-residents who are collective investment vehicles (whether open-ended or closed), pension funds and other bodies which either do not trade or whose client trade is outside the financial area, Statement of Practice 03/02 "Tax Treatment of Derivative Transactions" will be applied.
> 22. ... [10] The criteria for deciding whether a non-resident financial company is an investment company or a trading company are the same as those which apply to a resident company.
> 23. Where there is trading in the UK, no assessment is due on the non-resident when the Investment Manager Exemption applies. Liability of the non-resident is instead limited to tax deducted at source.

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10 The omitted text discusses whether the financial trade is carried on in the UK; see 14.8.2 (Buying and selling through an agent). This is different from the question of whether there is a trade.

33.3 Meaning of "investment manager"

For the IME non-residents IT rule, s.827(1) ITA provides a commonsense definition:

> In this Chapter "investment manager" means a person who provides investment management services.

33.4 Meaning of "broker"

The ITH provides:

> **926. NRs: Machinery of assessment: commodity markets: broker**
> A few words are called for about an important market operator, the broker. London has been a great market for centuries. Until a few decades ago vast amounts of produce were landed in, or trans-shipped in London docks and it was here and in other ports that the markets grew. They are run by Trade Associations which lay down rules designed to secure a fair, orderly and open market; to provide for membership, and to consider things like rates of brokerage. The actual constitution of the different markets varies but one would normally find as members some big producers, some major users, both of whom may have a seat in the market ring, the place of business. But the central character is the broker. A broker is a negotiator for commission, who will sell or buy for clients. Brokers have a long history, but, in modern usage, Bowstead, the writer of the standard work on agency, describes the broker in this way–
>
> > "A broker is an agent whose ordinary course of business is to negotiate and make contracts for the sale and purchase of goods and other property of which he is not entrusted with the possession or control."
>
> Payne, a writer on British Commercial Institutions, says this of an import broker–
>
> > "The function of a broker is to bring two parties together for the purpose of concluding a contract. Brokers are generally produce brokers with whose aid very large transactions take place at the chief importing ports. They are often specialists who, through long experience of markets ... are able to buy and sell to better advantage than could the general import merchant ... he (the broker) is not associated with the physical movement of the goods, nor with clearing them through Customs. After selling a consignment by auction, or by private treaty, the broker is paid a commission or fee (brokerage) which, with the other expenses of sale is deducted from the gross selling price."
>
> Brokers are thus associated with the great commodity markets and exchanges, professional negotiators who will act for buyers and sellers and have nothing to do with the work-a-day business of handling or insuring the goods. They constitute an essential link in the market mechanism, in making the function of the market-place in determining price, available to their clients. Another odd quality of brokers is that the same broker can, by the custom of certain markets,

> act both for buyer and seller.
> This means in practice that if A has asked a broker to sell something and B has asked the same broker to buy the same thing, the broker can match the two. The market rules would require that the broker does this business in the open (so that any other broker can step in if he wishes) and that preserves the idea of open market dealing and the natural protection which it gives to buyer and seller. Although the broker has acted for both parties the open nature of the market mechanism ensures that the price is a fair market price. ...
> **939 NRs: when to accept the TMA 70 s.82 broker exemption**
> **939. General**
> Brokers and general commission agents take a very limited part in the marketing process. They are there to make the advantages of the market-place available to their clients. Whatever the terms mean, we do not accept as a broker or as a general commission agent a man who does everything the client himself would do in running the business were he himself here to do it, even if the agent acts for more than one client. Both expressions are primarily to do with commodity markets and that is what they were really intended for.
> But over the years the application of the broker and general commission agent exemption has been extended. Stockbrokers, for example, will generally fall within Section 82(1) [TMA]. We have certainly accepted that there can be general commission agents and brokers in the field of shipping and that the exemption is sometimes appropriate. In insurance, on the other hand, we resist the suggestion that an underwriting agent can be a general commission agent. Insurance brokers will not normally be carrying on a non-resident's trade. If it seems that they do then they will arguably be acting in the capacity of underwriting agents and we would deny the exemption. If, in Districts, there are cases outside the usual commodity markets, where exemption under Section 82(1) appears to have been given but this treatment has not definitely and fairly recently, say within the last twenty years, been approved or condoned by International Division, it would be sensible to consider asking for advice on the next convenient occasion.

33.5 IME IT relief

SP 1/01 explains:

> 10. ... For income tax [the investment manager exemption] raises the threshold for chargeability so that the same criteria apply when there is no treaty protection in the form of a permanent establishment article.

For individuals and trustees, non-residents IT relief applies to "disregarded income". This term includes "disregarded transaction income". This is where the IME non-residents rule comes into play. For individuals and trusts, s.814 ITA provides:

> (1) Subsection (2) applies if a non-UK resident carries on (alone or in partnership) a business through a broker in the UK.
> (2) Income is "disregarded transaction income", subject to subsection (6), if—
> (a) it is transaction income, and
> (b) the independent broker conditions are met in relation to the transaction in question.
> (3) Subsection (4) applies if a non-UK resident carries on (alone or in partnership) a business through an investment manager in the UK.
> (4) Income is "disregarded transaction income", subject to subsection (6), if—
> (a) it is transaction income, and
> (b) the independent investment manager conditions are met in relation to the transaction in question.

For non-resident companies the drafting is similar and the result is the same. Non-residents IT relief applies to "disregarded company income". Section 816 ITA provides:

> (1) For the purposes of this Chapter income arising to a non-UK resident company is "disregarded company income" if it is ...
> (c) income arising from a transaction carried out on behalf of the non-UK resident company in the course of the company's trade through a broker in the UK, in relation to which the independent broker conditions are met,
> (d) income arising from an investment transaction carried out on behalf of the non-UK resident company in the course of the company's trade through an investment manager in the UK, in relation to which the independent investment manager conditions are met, ...

33.5.1 *Transaction income*

Section 814(5) ITA provides the definition:

> In this Chapter "transaction income", in relation to a transaction carried out through a broker or investment manager in the UK on behalf of a non-UK resident, means income which arises to the non-UK resident from—
> (a) so much of the non-UK resident's business carried on (alone or in partnership) through the broker or investment manager as relates to the transaction, or

(b) property or rights which, as a result of the transaction, are used by, or held by or for, the broker or investment manager on behalf of the non-UK resident.

The legislation deals with brokers and then investment managers, but in this discussion I reverse the order as investment managers are more important in practice.

33.6 Investment manager conditions

Section 818(1) ITA provides:

> The independent investment manager conditions are met in relation to an investment transaction carried out on behalf of a non-UK resident by an investment manager in the UK if conditions A to E are met.

I refer to these as "**investment manager conditions A to E**".

33.6.1 *Investment manager conditions A and B*: *investment manager*

Section 818 ITA provides:

> (2) Condition A is that at the time of the transaction the investment manager is carrying on a business of providing investment management services.
> (3) Condition B is that the transaction is carried out in the ordinary course of that business.

These are the equivalent of broker conditions A and B.

33.6.2 *Investment manager condition C: arm's length rule*

Section 818(4) ITA provides:

> Condition C is that, when the investment manager acts on behalf of the non-UK resident in relation to the transaction, the relationship between them, having regard to its legal, financial and commercial characteristics, is a relationship between persons carrying on independent businesses dealing with each other at arm's length.

SP 1/01 provides:

> 35. The manager must act for the non-resident in an independent capacity. This means ascertaining whether, having regard to its legal, financial and commercial characteristics, the relationship between the manager and the non-resident is a relationship between persons carrying on independent businesses that deal with each other on arm's length terms.

This is vague, so the SP offers two bright line tests which offer a safe harbour:

> 36. The relationship will be considered to be independent if the non-resident has the following characteristics:
> (a) the non-resident is a widely held collective fund or, if not,
> (b) the non-resident is not a widely held collective fund but is either being actively marketed with the intention that it become one or is being wound up or dissolved.
> 37. A fund will be regarded as widely held if either no majority interest in the fund is ultimately held by five or fewer persons and persons connected with them, or no interest of more than 20% is held by a single person and persons connected with that person. The fund may need to establish a track record before new investors are obtained and will therefore have 18 months from the commencement of trading in the UK to meet the widely held test. Where investment management services are provided to a collective investment scheme constituted as a partnership, participants in the scheme will not be regarded as connected persons for this purpose if their only connection is membership of the partnership. This means that if the investment manager is a partner in the fund it will not be treated as connected with the other partners in the fund for the purpose only of the Independent Capacity Test, although there may still otherwise be connection under s 839 TA 1988/s 993 ITA 2007 between the participants, for example as partners in another capacity.
> 38. Actively marketed means there must be evidence of ongoing genuine attempts to obtain third party investment into the fund in order to meet the widely held test and that the terms on which interests in the fund are offered are not prohibitive or discriminatory for that class of business.
> 39. If the fund has one of the above two characteristics the independent capacity test will be met without the need to refer to any other factors.
> 40. In other cases the independent capacity test will be met:
> (a) where the provision of services to the non-resident and persons connected with the non-resident is not a substantial part of the investment management business. Where that part does not exceed 70% of the investment manager's business, either by reference to fees or to some other measure (where that would be more appropriate), it will not be regarded as substantial. Further, if in the first 18 months from the start of a new investment management business the services provided to the non-resident exceed 70% of the business, they will not be treated as a substantial part of the business

provided that they are consistently below 70% in subsequent periods.

(b) where the provision of services to the non-resident represents more than 70% of the investment manager's business 18 months after the start of a new investment management business but that was for reasons outside the manager's control and the manager had taken all reasonable steps to bring it below 70%. The investment manager will be expected to provide all relevant information to support a contention that the services are a substantial part of the manager's business for reasons beyond the manager's control and to demonstrate what steps have been taken to rectify that position.

If neither of these two tests is satisfied one is back to the vagueness of the law:

> 41. If none of the above tests are satisfied HMRC will have regard to the overall circumstances of the relationship between the non-resident and the investment manager in determining whether they are carrying on independent businesses that deal with each other on arm's length terms. It is not possible to describe every scenario in which the relationship may still meet this test but the guidance in this Statement of Practice should provide certainty to the vast majority of non-residents trading in the UK through an investment manager and HMRC will also continue to provide advice for any other circumstances.
> 42. Some funds adopt a master/feeder structure. Where the investment manager manages an opaque master fund, eg a company, which has feeder funds then the independence test will be applied as if the master fund were transparent by looking at the beneficial ownership of each feeder fund to determine whether the master fund is independent.
> 43. Similarly, if the investment manager acts for one or more sub-funds owned by an umbrella fund it is the beneficial ownership of the latter that will determine whether the independence test is met.
> 44. It should be noted that a subsidiary may be considered independent of its parent company for the purposes of the test, notwithstanding the parent's ownership of the share capital.

33.6.3 *Investment manager condition D: 20% rule*

Section 818(5) ITA provides:

> Condition D is that the requirements of the 20% rule are met (see s.819).

33.6.4 *Investment manager condition E: full remuneration*

Section 818 ITA(6) provides:

> Condition E is that the remuneration which the investment manager receives in respect of the transaction for the provision of investment management services to the non-UK resident is not less than is customary for that class of business.

This is the equivalent of broker condition C.

SP 1/01 explains the meaning of "customary remuneration":

> 60. The UK investment manager must receive remuneration at a rate that is not less than customary for the services. The legislation does not define what is "customary" nor does it specify from whom remuneration must be received although, as already explained, HMRC will not regard a UK investment manager as acting in an independent capacity on behalf of the non-resident unless the relationship between them is that of persons carrying on independent businesses and dealing with each other at arm's length.
>
> 61. HMRC will be guided by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations when determining whether a pricing structure applies the customary rate and will look at whether the net effect of any provision made or imposed by means of a transaction or series of transactions provides the UK investment manager with a level of remuneration which would have been achieved at arm's length. All circumstances will be taken into consideration, including whether that remuneration has been reduced below the arm's length rate in any way either before or after payment to the UK investment manager.
>
> 62. HMRC recognises that remuneration structures through which the non-resident pays fees in a particular class of investment management take numerous forms, with variations including, for example, investment terms intended to attract certain investors or to "lock in" an investment. The arm's length definition of customary rate for the independent investment manager means that such arrangements between unconnected parties would not jeopardise this test. Transactions made at arm's length may include directly or indirectly reduced or rebated fees for unconnected investors in the non-resident Similarly, rebated, reduced or zero fee arrangements which are made between the manager and the unconnected non-resident for genuine commercial reasons, such as where the manager is receiving a separate fee in respect of the assets in which the non-resident is investing, would be regarded as transactions made at arm's length.
>
> 63. In determining whether remuneration has been reduced below the arm's length rate in any way HMRC will consider both the remuneration received by the UK investment manager and any amounts payable to any person:
>
> – for services provided to the non-resident, or
> – in connection with the non-resident, or
> – that relate to the performance of the non-resident.
>
> These amounts, which may be payable by either the non-resident or the UK

investment manager, will be treated as reducing the remuneration received in the UK below the customary rate unless they can be shown to be at an arm's length rate.

64. HMRC consider that in order to meet the customary rate test fees payable to a UK investment manager should be recognised for UK tax purposes when earned. A cash payment may be deferred or reinvested in the fund but this should not affect the recognition of the fee income. As a result, the UK manager would pay tax on the fee for the period when earned and no difficulty with the customary rate test is envisaged in these circumstances. If cash settlement of management fees is deferred the manager may have effectively made a loan to, or investment in, the non-resident, as a result of which the return on that loan or investment would be attributable to the manager and may need to be taken into account for the 20% test.

65. Where a UK investment manager, a partner, director or employee of that manager, or a person connected with any of these, acquires a security or an interest of some other kind, in the non-resident or in another entity, for services provided by the manager:

– to the non-resident, or
– in connection with the non-resident,

the customary rate test will only be met if it can be shown that the manager or partner brings the security or other interest into charge to UK tax at its market value or, in the case of a director or employee, that the security or other interest is taxed as employment income in accordance with Part 7 ITEPA 2003. The definition of "security" here will be that found in s420 ITEPA 2003. An interest is intended to apply to an interest in a security or securities and any other interest not within the s420 ITEPA definition.

66. Where an option is brought into UK tax charge at full market value at the time it is exercised HMRC will not regard this remuneration as less than the arm's length rate for the purposes of the customary rate test.

67. Preferential investment terms involving reduced or rebated fees for directors or staff of the investment manager may be a benefit provided by reason of employment and thus may give rise to an employee income tax charge under ITEPA 2003. Similarly, where the investment manager is a partnership, preferential fee terms may be offered to partners who acquire interests in the non-resident, in which case the ensuing personal tax consequences will apply. HMRC will not ordinarily regard these terms as reducing the investment manager's fees for services below the arm's length amount unless significant UK tax avoidance or evasion is suspected, in which case all the facts and circumstances will be considered to determine whether the rate of remuneration is below the arm's length amount.

68. The vast majority of non-residents easily meet the customary rate test. However, HMRC has occasionally encountered structures in which offshore arrangements have been used to evade or avoid UK tax. Commonly, such structures involve arrangements whereby fees charged to the non-resident are diverted to an offshore vehicle at a non-arm's length rate. Such arrangements represent an abuse of the exemption, place compliant UK managers at a competitive disadvantage and may result in a non-resident failing to meet the

terms of the exemption unless remedial action is taken.

The SP then turns to consider what evidence may be required:

69. HMRC has published guidance in its International Manual on what documentation and evidence is required to demonstrate an "arm's length" reward. At the time of publication of this Statement that guidance appears at INTM433030 of the Manual which can be found at http://www.hmrc.gov.uk/manuals/intmanual/index.htm and it is advisable to check that the most up to date advice is being followed.
70. The legislation considers the obligations and liabilities of the non-•resident and whether the non-resident is exempt from UK tax on its UK trading profits. A non-resident may be a taxable person and in considering whether that is the case, and whether the UK agent has been rewarded with an arm's length rate, it may be appropriate in some circumstances for HMRC to ask for information such as statutory financial statements of the non-resident and its agents and a full and factual functional analysis of all services provided to the non-resident.
71. In circumstances where such information is requested to ascertain whether the remuneration has been at the customary rate HMRC would normally ask the UK investment manager, but in some circumstances may ask the non-resident, to provide such information as may reasonably be considered necessary. The information powers available to HMRC would include those relevant to the tax liabilities of the non-resident but where reasonable cooperation is provided by the UK investment manager and/or, where appropriate, the non-resident it is intended that a reasonable opportunity will be given to supply the information voluntarily before the use of information powers is considered.
72. Where appropriate documentation, including a factual functional analysis and an acceptable transfer pricing methodology, is in place to support a tax return, the investment manager will have an opportunity to agree an adjustment to the return to meet the customary rate test or for any other reason, or to have adjustments determined through litigation where such an agreement has not been reached, without the non-resident having thereby failed the customary rate test.
73. However, where the investment manager does not have the appropriate documentation and methodology in place at the time of making a return and the remuneration for that period is less than the arm's length rate, it is possible that the customary rate test has not been met. HMRC would expect the non-resident and the investment manager to ensure that adequate measures are taken to prevent the fund or its investors being exposed to UK tax and will give reasonable notice of possible action, and the reasons for it, to both the non-resident and its agents if it discovers any circumstances in which the non-resident may not have met the Investment Manager Exemption tests.
74. Each case will be considered on its own facts and it is possible that appropriate corrective action through adjustment to the customary rate will still enable the test to be met. It is not possible to describe every scenario but this general approach is intended to provide certainty on what the legislation requires and to reassure non-residents that a disproportionate outcome will not arise from

a corrected failure to meet the test.

33.7 The 20% rule

Section 819(1) ITA provides:

> The requirements of the 20% rule are met if conditions A and B are met.

I refer to these as "**20% rule conditions A and B**".

> (2) Condition A is that in relation to a qualifying period[11] it has been or is the intention of the investment manager and the persons connected with the investment manager that at least 80% of the non-UK resident's relevant disregarded income[12] should consist of amounts to which none

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11 Section 820 ITA provides:

"(1) This section applies for the purposes of this Chapter.

(2) If section 819 applies for the purposes of section 813, a "qualifying period" means—

(a) the tax year in which the transaction income is chargeable to income tax, or

(b) a period of not more than 5 years comprising two or more tax years including that one.

(3) If section 819 applies for the purposes of section 816, a "qualifying period" means—

(a) the accounting period of the non-UK resident company in which the transaction in question is carried out, or

(b) a period of not more than 5 years comprising two or more complete accounting periods including that one."

12 Section 821 ITA provides:

"(1) This section applies for the purposes of this Chapter.

(2) If section 819 applies for the purposes of section 813, the "relevant disregarded income" of the non-UK resident for the qualifying period is the total of the non-UK resident's income for the tax years comprised in the qualifying period which derives from the transactions mentioned in subsection (4).

(3) If section 819 applies for the purposes of section 816, the "relevant disregarded income" of the non-UK resident company for the qualifying period is the total of the non-UK resident company's income for the accounting periods comprised in the qualifying period which derives from the transactions mentioned in subsection (4).

(4) The transactions referred to in subsections (2) and (3) are investment transactions—

(a) carried out by the investment manager on the non-UK resident's behalf,

> of them has a beneficial entitlement.
> (3) Condition B is that, so far as there is a failure to fulfil that intention, that failure—
> (a) is attributable (directly or indirectly) to matters outside the control of the investment manager and persons connected with the investment manager, and
> (b) does not result from a failure by any of them to take such steps as may be reasonable for mitigating the effect of those matters in relation to the fulfilment of that intention.

33.7.1 *Beneficial entitlement*

Section 822(1) ITA provides:

> This section applies for the purposes of this Chapter.

In fact the expression "beneficial entitlement" only appears in the 20% rule condition A, s.819(2) ITA, so the definition is only needed for that purpose.

> (2) A person has a "beneficial entitlement" to relevant disregarded income if the person has or may acquire a beneficial entitlement that is, or would be, attributable to the relevant disregarded income as a result of having an interest or other rights mentioned in subsection (3).
> (3) The interests and rights referred to in subsection (2) are—
> (a) an interest (whether or not an interest giving a right to an immediate payment of a share in the profits or gains) in property in which the whole or any part of the relevant disregarded income is represented, or
> (b) an interest in, or other rights in relation to, the non-UK resident.

33.7.2 *Position where 20% rule not met*

Section 823 ITA provides:

> (1) This section applies in the case of an investment transaction in

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> and
> (b) in relation to which the independent investment manager conditions are met, ignoring the requirements of the 20% rule."

relation to which the independent investment manager conditions are met, except for the requirements of the 20% rule.

(2) This Chapter has effect as if the requirements of that rule were met in relation to the transaction but only in relation to—

(a) so much of the transaction income of the non-UK resident as falls within subsection (3), if this section applies for the purposes of section 813, or

(b) so much of the income of the non-UK resident company deriving from the transaction as falls within subsection (3), if this section applies for the purposes of section 816.

(3) Income falls within this subsection if it does not represent income—

(a) which is relevant disregarded income of the non-UK resident, and

(b) to which the investment manager or a person connected with the investment manager has or has had any beneficial entitlement.

Section 824 ITA (non-resident collective investment scheme) is not discussed here.

33.7.3 *HMRC practice*

SP 1/01 provides:

> 45. In essence the requirement is that the investment manager and persons connected with it, including connected charities, must not have a beneficial entitlement to more than 20% of the non-resident's chargeable profit arising from transactions carried out through the investment manager. The definition of connected persons is that in s 839 TA 1988/s 993 ITA 2007.
>
> 46. Management fees paid to the investment manager and persons connected with it are not included in the chargeable profit provided they would be allowable in computing the profit of the non-resident were it chargeable to UK tax. This applies equally to incentive fees, performance fees or incentive allocations which are calculated by reference to any increase in the net asset value or profits of the relevant non-resident. This treatment of incentive allocations is explained further below.
>
> 47. Where the 20% threshold is exceeded, the part of the income of the non-resident to which the investment manager and connected persons are beneficially entitled is excluded from the limitation of charge. The limitation of charge will apply to the part to which they are not beneficially entitled provided the other tests in the investment manager provisions are met.
>
> 48. The 20% test is treated as satisfied throughout any period, not exceeding five years, for which it is met in respect of the total taxable income of the period arising from transactions carried out through the investment manager. It is also treated as satisfied if the manager intended to meet that test but failed to do so, wholly or partly, for reasons outside the manager's control, having taken any

reasonable steps to fulfil that intention. This means that the manager must fulfil the intention to keep its beneficial entitlement within 20% of the total taxable income for the period insofar as it is reasonable to do so, but is not required to get within that figure at any cost, for instance where there are good commercial reasons for not achieving that.

49. This is an example of how the test may be met throughout a period of five years:

Years	1	2	3	4	5
Taxable income of non-resident	£100	£200	£200	£250	£250
Entitlement of manager to above	£32	£58	£40	£35	£5
Expressed as percentage for each year	32%	29%	20%	14%	2%
Average % over qualifying period	32%	30%	26%	22%	17%

It may be assumed that the test is satisfied for year one because (a) in this example it was the manager's intention to have a beneficial entitlement to an average of 20% or less in aggregate over a five year period and (b) that intention was fulfilled. Had the 20% beneficial entitlement been achieved before the five years were up, then that shorter period would have been the qualifying period. A second qualifying period of up to five years could include years two, three, four, five and six and so on.

50. As with any other tests for the exemption, unless specified otherwise, the UK tax rules regard companies, including LLCs, as opaque and the FA 2003 rules apply, while partnerships are transparent and FA 1995 applies. In addition, the rule for non-resident companies at Schedule 26(5) FA 2003 treats partnership collective investment schemes in which they invest as assumed companies for the purposes of the 20% test.

51. In relation to a tax-transparent fund having overseas investors, the non-residents will be participants in the fund. In such circumstances the 20% test would be automatically broken where a non-resident participant is connected to the investment manager since this would mean that all the non-resident participants were connected under s 839(4) TA 1988/s 993(4) ITA 2007 by virtue of their being partners in the same partnership. The investment manager and connected persons would then be entitled to all the income of that non-resident. Accordingly, where the investment management services are provided to a collective investment scheme (as defined in the Financial Services and Markets Act 2000) the 20% test is applied by looking at the scheme as a whole rather than at the individual participators. It is not then relevant that the investment manager may be connected to the non-resident as partner (s 127(10) and paragraph 5 Schedule 26 FA 2003) or that the non-resident participants themselves carry on a financial trade as the availability of the exemption is instead tested solely by reference to the nature of the activities of the notional company represented by the scheme.

52. In certain circumstances the investment manager may be connected with the participants because both are partners in one or more partnerships which have an interest in the fund in question. Where the 20% test is failed as a consequence of aggregating the manager's income with that of certain partners who are not

connected persons otherwise than as a result of s 839(4) TA 1988/s 993(4) ITA 2007, ie by being partners in a partnership, the failure will be regarded as a failure under s 127(4)(b) FA 1995 and paragraph 4(b) Schedule 26 FA 2003 to fulfil an intention to satisfy the test. But in certain situations that failure will be considered as—

(a) attributable to matters outside the control of the manager and persons connected with it; and
(b) as not being the result of a failure to take reasonable steps to mitigate the effect of those matters in relation to the fulfilment of that intention.

In those situations the 20% test will be met. The legislation will be applied in this way where:

– the connected persons are partners other than solely in a fund under consideration; and
– partnership is the only reason that the manager is connected with them.

A remarkable fudge.

53. Where overseas pension funds are set up under trust the trustees do not have beneficial ownership of the pension fund income although they may be the legal owners. The 20% test will not therefore apply where the trustee is connected to the UK investment manager. In practice it would be unusual for an overseas pension fund to be carrying on a financial trade. ...[13]

55. Some non-residents remunerate investment managers with profit or incentive allocations and in consultations HMRC, investment managers and advisors reached a consensus that these are performance fees in substance. As such, these are income in nature and where they are recognised by the UK manager as fee income the allocations may be treated as fees payable by the non-resident when computing the chargeable profit. Furthermore, where HMRC is satisfied that some of the allocations are due to an overseas service provider as remuneration for those services at the arm’s length rate those allocations will have the same treatment in computing relevant excluded income.

56. Deferred fees, or securities or interests provided as reward, may in turn generate some form of return. The legislation draws no distinction between the forms in which the profits of the fund are attributed to deferred fees or other investments as the test is based on beneficial entitlement to the chargeable profits of the non-resident and if the manager’s beneficial entitlement to those profits, including the return on the securities, interests or deferred fees, exceeds 20% the test will not have been met.

57. Options to acquire any securities or interests in the non-resident, within the meanings at s 420 ITEPA 2003, need only be considered in the context of the 20% test when the options are exercised.

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13 The paragraph omitted here discusses “control”; see 63.4.2 (Control over a company's affairs).

58. Some investments in a non-resident may be linked to structured products issued to customers which provide a return based on the performance of the non-resident, an example of which would be a bank investing in a non-resident fund and selling a product to a customer on which the return is linked to the performance of the fund. In such circumstances the beneficial entitlement to the income of the non-resident remains with the investor in the non-resident, in this example the bank, and not the holder of the structured product, ie the customer.

Interaction of the 20% test and the independence test.

59. The independence test and the 20% test apply quite separately. For example, a UK investment manager acts for an overseas trading fund constituted as a company. If the investment manager is not acting in an independent capacity in relation to the fund company then the whole of the income of the fund is liable to assessment. If the independence test is satisfied, then the 20% test must be separately addressed. If the investment manager's interest in the fund company is 25% then that share of the fund's trading income is liable to assessment.

33.8 Investment transaction

Section 827 ITA provides the definition:

(2) In this section "investment transaction" means any transaction of a description specified for the purposes of this section in regulations made by the Commissioners for Her Majesty's Revenue and Customs.
(3) Provision made in regulations under subsection (2) may, in particular, have effect in relation to the tax year current on the day on which the regulations are made.

Kitty Usher (Economic Secretary to the Treasury) gave the following assurance in Parliament:

All transactions that currently meet the definition of "investment transaction" in primary legislation will be included in the regulations made under the new power, so investment managers can be reassured that all transactions that currently qualify will continue to do so. HMRC has also said that it will agree with the industry and publish in guidance a statement of assurance about handling any future changes to the transactions that qualify for the investment manager exemption.[14]

The regulations are the Investment Manager (Specified Transactions) Regulations 2009. They are six pages long, so a full discussion would be

14 Public Bill Committee 20 May 2008 Hansard Col 315.

a lengthy affair.

The label "investment transaction" is not entirely appropriate because the transaction will be a *trading* transaction and the so-called investment will be trading stock.

SP 1/01(not set out here) discusses the pre-2008 definition of investment transaction.

33.9 Independent broker conditions

Section 817 ITA provides:

> (1) The independent broker conditions are met in relation to a transaction carried out on behalf of a non-UK resident by a broker in the UK if—
> (a) conditions A to D are met, if this section applies for the purposes of section 813 [individuals/trustees], or
> (b) conditions A to C and E are met, if this section applies for the purposes of section 816 [companies].

I refer to these as **"broker conditions A to E"**, to avoid confusion with the other conditions in this legislation.

33.9.1 *Broker conditions A and B: broker's business*

Section 817 ITA provides:

> (2) Condition A is that at the time of the transaction the broker is carrying on the business of a broker.
>
> (3) Condition B is that the transaction is carried out by the broker in the ordinary course of that business.

The ITH provides:

> **940. NRs: accepting TMA 70 s82 broker exemption: in course of business**
> The exemption in Section 82(1) applies only to transactions which the broker carries out (on behalf of the non-resident) "in the ordinary course of his business as such". In modern times it has become common for brokers to extend their business beyond mere "broking" but it does not

> follow that, just because what they do is now customarily done by brokers, they do it in the ordinary course of their business as brokers. Thus stockbrokers and commodity brokers often provide investment management schemes for clients. But investment management does not thereby become an ordinary function of a broker. However, there are special provisions for investment managers which are considered in ITH951.

33.9.2 *Broker condition C: full remuneration*

Section 817(4) ITA provides:

> Condition C is that the remuneration which the broker receives in respect of the transaction for the provision of the services of a broker to the non-UK resident is not less than is customary for that class of business.

33.9.3 *Broker condition D: UK representative*

Section 817(5) ITA provides:

> Condition D is that the broker does not fall for the purposes of section 126 of, and Schedule 23 to, FA 1995 to be treated as a UK representative of the non-UK resident in relation to
> [1] any other income which is chargeable to income tax, or
> [2] amounts which are chargeable to capital gains tax,
> for the same tax year as the transaction income.

This condition applies to individuals/trustees and not to companies.

33.9.4 *Broker condition E: permanent establishment*

Section 817(6) ITA provides:

> Condition E is that the broker does not fall to be treated as a permanent establishment of the non-UK resident company in relation to any other transaction of any kind carried out in the same accounting period of the non-UK resident company as the transaction in question.

The wording is the equivalent of broker condition D for companies (using the company tax concept of PE rather than the individual/trustee concept of branch/agency.) Of course it would be simpler if the two were aligned.

33.10 Transactions through brokers

Section 828 ITA provides:

> (1) For the purposes of this Chapter a person is regarded as carrying out a transaction on behalf of another if the person—
> (a) undertakes the transaction, whether on behalf of or to the account of the other, or
> (b) gives instructions for it to be so carried out by another.
> (2) In the case of a person who acts as a broker or investment manager as part only of a business, this Chapter has effect as if that part were a separate business.

33.11 UK rep rule

33.11.1 *UK rep rule for brokers*

Section 127(1) FA 1995 provides:

> For the purposes of section 126 above and Schedule 23 to this Act, none of the following persons shall be capable of being the non-resident's UK representative in relation to income or other amounts falling within paragraphs (a) to (c) of section 126(2) above, that is to say ...
> (b) where the income arises from, or the other amounts are chargeable by reference to, so much of any business as relates to transactions carried out through a broker and falling within subsection (2) below, that broker;

This takes us to s. 127(2) FA 1995 which provides:

> For the purposes of subsection (1)(b) above where any income arises from, or other amounts are chargeable by reference to, so much of any business as relates to any transaction carried out through a broker, that transaction shall be taken, in relation to the income or other amounts ("the taxable sums"), to fall within this subsection if—
> (a) at the time of the transaction, the broker was carrying on the business of a broker;
> (b) the transaction was carried out by the broker on behalf of the

non-resident in the ordinary course of that business;

(c) the remuneration which the broker received for the provision of the services of a broker to the non-resident in respect of that transaction was at a rate not less than that which would have been customary for that class of business; and

(d) the non-resident does not fall (apart from this paragraph) to be treated as having the broker as his UK representative in relation to any income or other amounts not included in the taxable sums but chargeable to tax for the same chargeable period.

Paragraphs (a) to (d) are the equivalent of broker conditions A to D; see 33.9 (Broker conditions).

The IT Self Assessment Manual explains:

> 7.36 There are four conditions which must all be met before the specific exemption for brokers can apply. These are as follows.
>
> - The broker must be carrying on the normal business of a broker in a market where brokers normally act.
> - The transaction must be carried out by the broker in the ordinary course of the broker's business.
> - The broker's fee must be at least the customary fee for that class of business.
> - The non-resident must not, during the same chargeable period, carry out any trading transactions through the broker other than those which are excluded by this rule.
>
> The purpose of these conditions is to exempt only those brokers who are acting in the ordinary course of their business on arm's length terms.

33.11.2 *UK rep rule for investment managers*

Section 127(1) FA 1995 provides:

> For the purposes of section 126 above and Schedule 23 to this Act, none of the following persons shall be capable of being the non-resident's UK representative in relation to income or other amounts falling within paragraphs (a) to (c) of section 126(2) above, that is to say ...
>
> (c) where the income arises from, or the other amounts are chargeable by reference to, so much of any business as relates to investment transactions carried out through an investment manager and falling

within subsection (3) below, that manager;...[15]

This takes us to s. 127(3) FA 1995 which provides:

> For the purposes of subsection (1)(c) above where any income arises from, or other amounts are chargeable by reference to, so much of any business as relates to any investment transaction, that transaction shall be taken, in relation to that income or those amounts ("the taxable sums"), to have been carried out through an investment manager and to fall within this subsection if—
> (a) the transaction was carried out on behalf of the non-resident by a person ("the manager") who at the time was carrying on a business of providing investment management services;
> (b) the transaction was carried out in the ordinary course of that business;

(a) and (b) are the equivalent of investment manager conditions A and B. The IT Self Assessment Manual provides a convenient summary:

> 7.37 The four conditions applying to brokers are mirrored in the conditions which must be met before the exemption for investment managers can apply. These are as follows.
>
> - The investment manager must be carrying on the business of providing investment management services.
> - The transaction must be carried out by the investment manager in the ordinary course of the investment management business.
> - The investment manager's fee must be at least the customary fee for that class of business.
> - The non-resident must not, during the same chargeable period, carry out any trading transactions through the investment manager, other than those which are excluded by this rule.
>
> 7.38 In addition, the following three further conditions must also be met.
>
> - The transactions must be investment transactions, (Paragraphs 7.42–7.54).
> - The investment manager must act on behalf of the non-resident in an independent capacity, (Paragraphs 7.45–7.48).
> - The investment manager must not be entitled to more than 20% of

15 The rest of s.127(1) deals with alternative finance arrangements and Lloyds, not discussed here.

the profit from the transactions on behalf of the non-resident: (Paragraphs 7.49–7.52).

7.39 The effect of these conditions is to exempt only those investment managers who are acting in the ordinary course of their business on arm's length terms and are independent of the non-resident.

33.11.3 *Independent capacity condition*

The next condition is s.127(3)(c) FA 1995:

> the manager, when he acted on behalf of the non-resident in relation to the transaction, did so in an independent capacity;

Section 127(18) defines "acting in an independent capacity":

> For the purposes of this section a person shall not be regarded as acting in an independent capacity when acting on behalf of the non-resident unless, having regard to its legal, financial and commercial characteristics, the relationship between them is a relationship between persons carrying on independent businesses that deal with each other at arm's length.

This is the equivalent of investment manager condition C.

The remaining conditions of s.127(3) are the equivalent of investment manager conditions D and E:

> (d) the requirements of subsection (4) below are satisfied in relation to the transaction; and
> (e) the remuneration which the manager received for the provision to the non-resident of the investment management services in question was at a rate which was not less than that which would have been customary for that class of business.

33.11.4 *The 20% rule*

Section 127(4) FA 1995 sets out the equivalent of the 20% rule:

> (4) Subject to subsections (9) to (11) below, the requirements of this subsection are satisfied in relation to any transaction if—
> (a) there is a qualifying period in relation to which it has been or is the intention of the manager and the persons connected with him that

the non-resident's relevant excluded income should, as to at least 80 per cent, consist of amounts to which neither the manager nor any such person has a beneficial entitlement; and

(b) to the extent that there is a failure to fulfil that intention, that failure—

(i) is attributable (directly or indirectly) to matters outside the control of the manager and persons connected with him; and

(ii) does not result from a failure by the manager or any of those persons to take such steps as may be reasonable for mitigating the effect of those matters in relation to the fulfilment of that intention.

These are the equivalent of the 20% rule conditions A and B. The remainder of s.127 duplicates the ITA:

(5) For the purposes of this section any reference to the relevant excluded income of the non-resident for a qualifying period is a reference to the aggregate of such of the profits and gains of the non-resident for the chargeable periods comprised in the qualifying period as—

(a) derive from transactions carried out by the manager while acting on the non-resident's behalf; and

(b) for the purposes of Chapter 1 of Part 14 of the Income Tax Act 2007 (limits on liability to income tax of non-UK residents) would fall (apart from the requirements of section 819 of that Act) to be treated as disregarded income (see section 813 of that Act) for any of those chargeable periods.

(6) For the purposes of this section any reference to an amount of relevant excluded income to which a person has a beneficial entitlement is a reference to so much of any amount to which he has or may acquire a beneficial entitlement by virtue of—

(a) any interest of his (whether or not an interest giving a right to an immediate payment of a share in the profits or gains) in property in which the whole or any part of that income is represented, or

(b) any interest of his in or other rights in relation to the non-resident,

as is or would be attributable to that income.

(7) For the purposes of subsections (4) to (6) above references to a qualifying period, in relation to any transaction, are references to any period consisting in or including the chargeable period for which the taxable sums are chargeable to tax, being, in a case where it is not that chargeable period, a period of not more than five years comprising two or more complete chargeable periods.

(8) Where there is a transaction which would fall within subsection (3) above but for its being a transaction in relation to which the requirements of subsection (4) above are not satisfied, this section shall have effect as if the transaction did fall within subsection (3) above but only in relation to so much of the amount of the taxable sums as does not represent any amount of the non-resident's relevant excluded income to which the manager or a person connected with him has or

has had any beneficial entitlement.

(9) Subsections (10) and (11) below shall apply, where amounts arise or accrue to the non-resident as a participant in a collective investment scheme, for the purpose of determining whether a transaction carried out for the purposes of that scheme, in so far as it is a transaction in respect of which any such amounts arise or accrue to him, is one in relation to which the requirements of subsection (4) above are satisfied.

(10) Those requirements shall be deemed to be satisfied in relation to the transaction wherever the collective investment scheme is such that, if the following assumptions applied, namely—

(a) that all transactions carried out for the purposes of the scheme were carried out on behalf of a company constituted for the purposes of the scheme and resident outside the UK, and

(b) that the participants did not have any rights in respect of the amounts arising or accruing in respect of those transactions other than the rights which, if they held shares in the company on whose behalf the transactions are assumed to be carried out, would be their rights as shareholders,

the assumed company would not, in relation to the chargeable period in which the taxable sums are chargeable to tax, be regarded for tax purposes as a company carrying on a trade in the UK.

(11) Where, on those assumptions, the assumed company would be so regarded for tax purposes, subsections (4) to (8) above shall have effect in relation to the transaction as if, applying those assumptions—

(a) references to the non-resident were references to the assumed company; and

(b) the following subsection were substituted for subsection (5) above, namely—

> "(5) In subsection (4) above the reference to the assumed company's relevant excluded income for a qualifying period is a reference to the aggregate of the amounts which would, for the chargeable periods comprised in the qualifying period, be chargeable to tax on that company as profits deriving from the transactions carried out by the manager and assumed to be carried out on the company's behalf."

(12) In this section "investment transaction" means any transaction of a description specified for the purposes of this section in regulations made by the Commissioners for Her Majesty's Revenue and Customs.

(13) Provision made in regulations under subsection (12) may, in particular, have effect in relation to the tax year current on the day on which the regulations are made.

(14) The preceding provisions of this section shall have effect in the case of a person who acts as a broker or provides investment management services as part only of a business as if that part were a separate business.

(15) For the purposes of this section—

(a) a person shall be taken to carry out a transaction on behalf of another where he undertakes the transaction himself, whether on behalf of or to the account of that other, and also where he gives instructions for it to be so carried out by another; and

(b) the references to the income arising from so much of a business as relates to

> transactions carried out through a branch or agency on behalf of the non-resident shall include references to income from property or rights which, as a result of the transactions, are used by, or held by or for, that branch or agency.

Section 127(17) gives standard definitions of "branch or agency", "collective investment scheme", "participant" and "connected persons" and these need not be set out here.

CHAPTER THIRTY FOUR

RATES OF INCOME TAX

34.1 IT rates – Introduction

This chapter considers rates of income tax from 2009/10. The FA 2009 makes changes from 2010/11 which I will discuss in the next edition of this work.

I concentrate on two common types of income: interest and dividends.

It may be helpful first of all to list the seven possible rates of income tax on individuals:

Rate of tax	**Amount**	**Applicable to**
Starting rate	10%	Savings income up to starting rate limit
Basic rate	20%	Other income up to basic rate limit
Higher rate	40%	Income above basic rate limit
Dividend ordinary rate	10%	Dividends up to basic rate limit
Dividend upper rate	32.5%	Dividends above basic rate limit
UK dividends under basic rate limit: effective rate (with tax credit)	0%	Dividends up to basic rate limit
UK dividends above basic rate limit: effective rate (with tax credit)	25%	Dividends above basic rate limit

Rates of tax on trustees and PRs are not considered here.

34.2 Basic/higher rates

Section 10 ITA introduces the basic/higher rates:

> (2) Income tax on an individual's income up to the basic rate limit is charged at the basic rate (except to the extent that, in accordance with section 12, it is charged at the starting rate for savings).
> (3) Income tax is charged at the higher rate on an individual's income above the basic rate limit.

These rates apply unless disapplied by any other provisions. The important provisions for our purposes are ss.12 and 13 ITA.

34.3 Starting rate for savings income

Section 12(1) ITA provides:

> Income tax is charged at the starting rate for savings (rather than the basic rate) on so much of an individual's income up to the starting rate limit for savings as is savings income.

Section 12 replaces the basic rate with a different (more favourable) rate.

34.3.1 *"Savings income"*

Savings income is defined in s.18 ITA:

> (1) This section applies for the purposes of the Income Tax Acts.
> (2) "Savings income" is income—
> (a) which is within subsection (3) or (4), and
> (b) which is not relevant foreign income charged in accordance with section 832 of ITTOIA 2005 (relevant foreign income charged on the remittance basis).

There are five categories of savings income within s.18(3) and (4):

> (3) Income is within this subsection if it is—
> (a) income chargeable under Chapter 2 of Part 4 of ITTOIA 2005 (interest),
> (b) income chargeable under Chapter 7 of Part 4 of ITTOIA 2005

(purchased life annuity payments), other than income from annuities specified in section 718(2) of that Act (annuities purchased from certain life assurance premium payments or under wills etc),
(c) income chargeable under Chapter 8 of Part 4 of ITTOIA 2005 (profits from deeply discounted securities), or
(d) income chargeable under Chapter 2 of Part 12 of this Act (accrued income profits).
(4) Income is within this subsection if—
(a) it is chargeable under Chapter 9 of Part 4 of ITTOIA 2005 (gains from contracts for life insurance etc), and
(b) an individual is, or personal representatives are, liable for income tax on it (under section 465 or 466 of that Act).

"Savings income" does not properly describe these categories of income, but it serves as a short label.

In short, the rates of tax on:
(1) UK interest; and
(2) foreign interest when the arising basis applies
are the starting/basic/higher rates, 10%/20%/40%.

34.3.2 *Rates of tax on interest under remittance basis*

If the remittance basis applies, foreign interest income[1] is taxed at the **basic**/higher rates, **20%**/40%. This is achieved by the clumsy but effective technique of providing that such income is not "savings income". How much is at stake? At most the difference between the starting rate and the basic rate, for income up to the starting rate limit. In 2009/10, this is 10% of £2,320 = £232.

Before the 2008 reforms I said:

> There is a (perhaps good) reason for dealing with foreign interest income in this way. A UK resident foreign domiciled individual will often have different types of foreign income. If he remitted only some of his income, it would be necessary, in the absence of this rule, to investigate whether the remitted income represents interest (taxable at 10%) or some other source of income (taxable at 20%). Because of this rule it is not necessary to ask this question.

1 Including the interest-like income of the other categories specified in s.18(4) ITA.

Now that the ITA mixed fund rule requires precisely that investigation, this has ceased to be a valid reason. But the amount of tax involved is trivial.

34.4 Rates of tax on dividend income

34.4.1 *"Dividend income"*

Dividend income is defined in s.19 ITA:

> (1) This section applies for the purposes of the Income Tax Acts.
> (2) "Dividend income" is income which is—
> (a) chargeable under Chapter 3 of Part 4 of ITTOIA 2005 (dividends etc from UK resident companies),
> (b) chargeable under Chapter 4 of that Part (dividends from non-UK resident companies),
> (c) chargeable under Chapter 5 of that Part (stock dividends from UK resident companies),
> (d) chargeable under Chapter 6 of that Part (release of loan to participator in close company), or
> (e) a relevant foreign distribution chargeable under Chapter 8 of Part 5 of ITTOIA 2005 (income not otherwise charged).
> (3) In subsection (2) "relevant foreign distribution" means a distribution of a non-UK resident company which—
> (a) is not chargeable under Chapter 4 of Part 4 of ITTOIA 2005, but
> (b) would be chargeable under Chapter 3 of that Part if the company were UK resident.

"Dividend income" does not properly describe these categories of income, but it serves as a short label.

34.4.2 *Rates of tax on dividend income*

Section 13 ITA provides:

> (1) Income tax is charged at the dividend ordinary rate on an individual's income which—
> (a) is dividend income,
> (b) would otherwise be charged at the basic rate, and
> (c) is not relevant foreign income charged in accordance with section 832 of ITTOIA 2005 (relevant foreign income charged on the

remittance basis).

(2) Income tax is charged at the dividend upper rate on an individual's income which—

(a) is dividend income,

(b) would otherwise be charged at the higher rate and

(c) is not relevant foreign income charged in accordance with section 832 of ITTOIA 2005.

The scheme of s.13 is to replace the basic/higher rate with different rates. Thus the rates of tax on UK dividend income are the dividend ordinary/upper rates, 10%/32.5%. After allowing the tax credit and grossing up, the effective rates on net UK dividends are 0%/25%.

Foreign dividend income is also taxed at the dividend ordinary/upper rates, 10%/32.5% when the arising basis applies, and with benefit of a tax credit and grossing up if the complex conditions of s.397AA ITTOIA are met. It would need a long chapter to discuss those conditions in full but I hope to deal with this topic in a future edition.

34.4.3 *Foreign dividend income under remittance basis: from 2008/09*

If the remittance basis applies, foreign dividend income taxed on the remittance basis does not fall within s.13 as it does not meet the condition of s.13(1)(c) and s.13(2)(c). This is consistent with the treatment of foreign interest income discussed above. However unlike foreign interest income, the amounts involved may be very substantial. The result is that for a remittance basis taxpayer who remits, foreign dividend income is taxed more heavily than UK dividend income. If the dividend income is from another MS, the discrimination is contrary to EU law.

34.4.4 *Foreign dividend income under remittance basis: 2005/06 and 2006/07*

The position in 2005/6 and 2006/7 is more complicated. I set out the analysis here because it neatly raises an important issue, which arises in several areas in tax, of whether unremitted income of a remittance basis taxpayer can be described as "chargeable to tax".

In the 2005/06 edition of this book I said that remitted dividend income (above the basic rate limit) was taxed at the higher rate:

> Where the remittance basis applies, the income is charged under s.832

ITTOIA (Chapter 2 of Part 8). So it does not fall within s.1B(1)(b)[i] or [ii] ICTA.

But HMRC did not agree.[2]

Section 1B ICTA provided:

Rates of tax applicable to distribution income

(1) In the case of so much of an individual's income which consists of—

(a) income chargeable under Chapter 3 of Part 4 of ITTOIA (dividends etc from UK resident companies etc.) (if any), and

(b) [i] dividends chargeable under Chapter 4 of Part 4 of that Act (dividends from non-UK resident companies) (if any) or

[ii] relevant foreign distributions chargeable under Chapter 8 of Part 5 of that Act (income not otherwise charged) (if any),

as is income falling within section 1(2)(b) [higher rate income], income tax shall, by virtue of this subsection, be charged at the dividend upper rate, instead of at the rate otherwise applicable to it in accordance with section 1(2)(b).

From Chapter 4 Part 4 ITTOIA

402 Charge to tax on dividends from non-UK resident companies

(1) Income tax is charged on dividends of a non-UK resident company.

...

403 Income charged

(1) Tax is charged under this Chapter on the full amount of the dividends arising in the tax year.

(2) Subsection (1) is subject to ... Part 8 (foreign income: special rules).

From Part 8 ITTOIA

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2 Tax Bulletin 84 provided:

SA Tax Returns Foreign Savings & Dividend Income - Remittance Basis of Taxation: Dividend Income

In the process of introducing the ITTOIA an inadvertent change was made to the law. This affects the rate of tax chargeable on foreign dividend income that is taxable on the alternative basis provided by Part 8 of ITTOIA (commonly known as the remittance basis).

From 6 April 2005 the top rate of tax chargeable on foreign dividend income on the remittance basis is 32.5% and not 40%. As this change did not come to light until after the 2005/06 self assessment return and tax calculator had been compiled and issued the self assessment system will automatically apply the former tax rate of 40% for higher rate taxpayers.

> ***832 Relevant foreign income charged on the remittance basis***
> *(1) If a person makes a claim under section 831(1) for a tax year in respect of relevant foreign income, income tax is charged on the full amount of the sums received in the UK in the tax year in respect of the income.*

HMRC did not explain how they reached its conclusion. The (subtle) point seems to be that the *charge* is under ss.402 and 687 ITTOIA. Section 403 ITTOIA does not impose the charge. It merely quantifies the amount on which income is charged. Likewise s.832 ITTOIA does not impose the charge, it merely quantifies the amount on which income is charged.[3] So the charge on remitted foreign dividends was under Chapter 4, Part 4 ITTOIA, and therefore qualified for the relief under s.1B(1)(b)[i] ICTA.

It is interesting that HMRC did not argue that ITTOIA should be read as imposing a 40% rate in 2005/06 and 2006/07because of a principle of continuity from the pre-ITTOIA law. This is right. The benefits of the tax law rewrite would be lost if one had to review the old legislation to see if it was different from the current legislation.

34.5 Settlor-interested trust: rates of tax on settlor

Section 619 ITTOIA provides (so far as relevant):

> **619 Charge to tax under Chapter 5**
> (1) Income tax is charged on—
> (a) income which is treated as income of a settlor as a result of section 624 (income where settlor retains an interest), ...
> (2) For the purposes of Chapter 2 of Part 2 of ITA 2007 (rates at which income tax is charged), where income of another person is treated as income of the settlor and is charged to tax under subsection (1)(a) ... above, it shall be charged in accordance with whichever provisions of the Income Tax Acts would have been applied in charging it if it had arisen directly to the settlor.

This is a welcome simplification from the rules which applied before 2006. Unfortunately the old rules applied for the IT settlement provisions and for s.720. The FA 2006 simplified the settlement provisions but

3 Hence the legislation stated that tax is charged "in accordance with s.832" not *under* s.832. See e.g. s.13 ITA.

overlooked s.720! So the old rules still need to be considered in that context.

What about foreign dividend income which qualifies for the s.624 remittance basis, but is later remitted and becomes taxable under the s.648 clawback?[4] This is taxable at the dividend ordinary/upper rates, 10%/32.5%.

34.6 Rates of tax on transferor within s.720 ITA

Section 745 ITA provides:

> (1) Income tax at the basic rate, the savings rate or the dividend ordinary rate is not charged under section 720 or 727 in respect of any income so far as it has borne tax at that rate by deduction or otherwise.
> (2) Subsection (1) does not affect the tax charged if section 724(2) applies (benefit provided out of income of person abroad charged in year of receipt).
> (3) Subsection (4) applies to any income that—
> (a) is treated as arising to an individual under section 721 or 728, and
> (b) apart from this Chapter is dividend income,
> so far as subsection (1) does not apply to the income.
> (4) The charge to income tax under section 720 or, as the case may be, section 727 operates by treating the income as if it were income within section 19(2) (meaning of "dividend income").

So there are two rules: one rule for dividend income; and another rule for other income. Dividend income is taxed at the rates usually applied to dividends: the dividend ordinary/dividend upper rates, with the benefit of the tax credit in the case of UK dividends. This also applies to foreign dividends of a foreign domiciled transferor if the usual s.720 foreign domicile defence does not apply (because the dividends are received in the UK).

Section 745 ITA provides a special rule for dividend income. It says nothing about interest. Accordingly, interest within s.720 is taxed at the basic/higher rates of 20%/40%.

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4 See 16.5 (Section 624 remittance gains).

CHAPTER THIRTY FIVE

NATIONAL INSURANCE CONTRIBUTIONS

35.1 NICs – Introduction

NICs should be regarded as a collection of seven more or less distinct taxes. Section 1(2) SSCBA classifies them semi-numerically:

> Contributions under this Part of this Act shall be of the following six classes—
> (a) Class 1, earnings-related, payable under section 6 below, being—
> (i) primary Class 1 contributions from employed earners; and
> (ii) secondary Class 1 contributions from employers and other persons paying earnings;
> (b) Class 1A, payable under section 10 below by persons liable to pay secondary Class 1 contributions and certain other persons;
> (bb) Class 1B, payable under section 10A below by persons who are accountable to the Inland Revenue in respect of income tax on general earnings in accordance with a PAYE settlement agreement;
> (c) Class 2, flat-rate, payable weekly under section 11 below by self-employed earners;
> (d) Class 3, payable under section 13 below by earners and others voluntarily with a view to providing entitlement to benefit, or making up entitlement; and
> (e) Class 4, payable under section 15 below in respect of the profits or gains of a trade, profession or vocation, or under section 18 below in respect of equivalent earnings.

The primary legislation does not apply in Northern Ireland, so the SSCBA refers to "Great Britain". (Northern Ireland has its own equivalent legislation.) The regulations apply in both jurisdictions, so they usually refer to the UK, or to "GB and Northern Ireland".

There are special rules for mariners, aircrew, diplomats and service personnel. These are not discussed here.

35.2 Meaning of "secondary contributor"

Section 6(3) SSCBA provides:

> The primary and secondary Class 1 contributions referred to in subsection (1) above are payable as follows—
> (a) the primary contribution shall be the liability of the earner; and
> (b) the secondary contribution shall be the liability of the secondary contributor; …

The identity of the secondary contributor is clearly crucial.

Section 7(1) SSCBA provides:

> For the purposes of this Act, the "secondary contributor" in relation to any payment of earnings to or for the benefit of an employed earner, is—
> (a) in the case of an earner employed under a contract of service, his employer;
> (b) in the case of an earner employed in an office with emoluments, either—
> (i) such person as may be prescribed in relation to that office; or
> (ii) if no person is prescribed, the government department, public authority or body of persons responsible for paying the emoluments of the office.

SSCER reg. 5(1) prevents avoidance by foreign employers seconding to the UK:

> For the purposes of section 4 of the Act[1] (Class 1 contributions), in relation to any payment of earnings to or for the benefit of an employed earner in any employment described in any paragraph in column (A) of Schedule 3 to these regulations, the person specified in the corresponding paragraph in column (B) of that Schedule shall be treated as the secondary Class 1 contributor in relation to that employed earner.

1 Section 4 Social Security Act 1975 is now s.7 SSCBA.

...

Column (A)	**Column (B)**
9. Employment by a foreign employer where— (a) in pursuance of that employment the personal service of the person employed is made available to a host employer; and (b) the personal service is rendered for the purposes of the business of that host employer; and (c) that personal service for the host employer begins on or after 6th April 1994.	9. The host employer to whom the personal service of the person employed is made available.

The identity of the employer is a question of contract/employment law.[2]

35.3 Meaning of "employed" and "self-employed"

Section 2(1) SSCBA provides:

(a) "*employed* earner" means a person who is gainfully employed in Great Britain either under a contract of service, or in an office (including elective office)[3] with general earnings chargeable to

2 Tax Bulletin 49 provides:

> "We would not seek to claim in isolation that there is a place of business [in the UK] where the overseas provider legally, and in exchange for a payment commensurate with the service, sub-contracts services to a UK business. And similarly we would also not normally attempt to claim in isolation that the unconnected UK business is the employer if it is genuinely not paying the mariners directly."

This is only relevant to mariners as others are caught by the SSCER.

3 The odd expression "elective office" is not defined and the words in brackets are otiose.

income tax under Schedule E;[4] and

(b) "*self-employed* earner" means a person who is gainfully employed in Great Britain otherwise than in employed earner's employment (whether or not he is also employed in such employment).

The SSCBA, confusingly, (mis)defines the word "employment" to include trades and professions.[5] But in the above definition the italicised terms "employed" and "self-employed" are used in more or less their ordinary meanings. (To add to the confusion, the SSCER deems some persons actually self-employed to be employees for NIC purposes and vice versa.) For convenience I generally abbreviate "employed earner" to "employee"; and I abbreviate a "self-employed earner" to "self-employed".

35.4 Three sets of rules

Tax Bulletin 79 explains:

> For NIC purposes the world can be usefully divided into:
> **European Economic Area (EEA)**[6]
> EC Treaty and EC Regulation 1408/71 applies to employees moving between EEA Member States to work. It modifies SSCBA 1992 and regulations.
> **RA/DCC Countries**[7]
> Bi-lateral Social Security agreements modify SSCBA 1992 and

4 The reference to Schedule E is obsolete since 2003, but it will be read to mean earnings formerly chargeable under Schedule E and now chargeable under equivalent provisions in ITEPA. But the entire phrase "with general earnings chargeable to IT under Schedule E" is otiose as everyone gainfully employed in GB under a contract of service or in an office will be "chargeable to IT under Schedule E". The words have survived since before 1956 (when they made sense, because many employments and offices were not then chargeable under Schedule E).

5 Section 122(1) SSCBA.

6 These countries are: Austria, Belgium, Cyprus (Republic of Cyprus not Northern Cyprus), Czech Republic, Denmark, Estonia, Finland, France, Germany, Gibraltar, Greece, Hungary, Iceland, Republic of Ireland, Italy, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Netherlands, Norway, Poland, Portugal, Spain, Slovakia, Slovenia, Sweden, Switzerland.

7 These countries are: Barbados, Bermuda, Bosnia-Herzegovina, Canada, Croatia, Guernsey, Israel, Jamaica, Japan, Jersey, Macedonia, Mauritius, Montenegro, New Zealand (Social Security Benefits only), Philippines, Republic of Korea, Serbia, Turkey, USA.

regulations.
Rest of The World ("ROW")
SSCBA 1992 and contributions regulations are unmodified.

Reciprocal agreements are not considered in this book. I first consider what the NI Manual calls "ROW" [rest of the world] rules, and then the EU rules.

35.5 ROW: Employed in GB

Unless the individual is gainfully employed *in GB*, he is not an employed or self-employed earner, and so in principle no NIC liability arises. I refer to this as the "employed in GB" rule.

Tax Bulletin 79 explains:

> This requires that employment duties take place here. However, this is wide enough to allow for some temporary or incidental duties of the employment to be performed outside the UK, if the UK is the place where the employment duties are usually performed.

35.5.1 *First year abroad*

Reg. 146 SSCR provides an extension to the employed in GB rule:

> (1) Where an earner is gainfully employed outside the United Kingdom, and that employment, if it had been in Great Britain or Northern Ireland, would have been employed earner's employment, that employment outside the United Kingdom shall be treated as employed earner's employment for the period for which under para (2)(a) contributions are payable in respect of the earnings paid to the earner in respect of that employment provided that—
> (a) the employer has a place of business in Great Britain or Northern Ireland (as the case may be);
> (b) the earner is ordinarily resident in Great Britain or Northern Ireland (as the case may be); and
> (c) immediately before the commencement of the employment the earner was resident in Great Britain or Northern Ireland (as the case may be).
> (2) Where, under para (1), the employment outside the United Kingdom is treated as an employed earner's employment, the following provisions shall apply in respect of the payment of contributions—

(a) primary and secondary Class 1 contributions shall be payable in respect of any payment of earnings for the employment outside the United Kingdom during the period of 52 contribution weeks from the beginning of the contribution week in which that employment begins to the same extent as that to which such contributions would have been payable if the employment had been in Great Britain or Northern Ireland (as the case may be);

(b) subject to regulations 148 and 148A, any earner by or in respect of whom contributions are or have been payable under sub-para (a) shall be entitled to pay Class 3 contributions in respect of any year during which the earner is outside the United Kingdom from and including that in which the employment outside the United Kingdom begins until that in which he next returns to Great Britain or Northern Ireland (as the case may be);

(c) Class 1A contributions and Class 1B contributions shall be payable in respect of the period specified in sub-para (a).

Thus employment outside the UK is treated as employment in the UK (and so subject to NIC) for 52 weeks, provided the following conditions are satisfied:

(1) The employer has a place of business in the UK.
(2) The employee is ordinarily resident in UK.
(3) The employee was UK resident immediately before the employment commenced.

NI Manual para 33027 provides:

Class 1: Workers Going to and Coming from Abroad – ROW – Change of employment

Change of employment overseas with the same employer

The 52 week period of continuing liability may cease when an employee changes employment. Whether or not an employee has entered into a new employment will be a question of fact. The contracts of employment will indicate if this were so.

Example

- Ralph was posted by the UK company to work in Australia for a period of 2 years as a General Manager of the Sydney office
- After 6 months he applied for promotion as a Overseas Sales Executive with a separate department of the UK company
- He was successful and immediately took up his new position in

> Malaysia
> The subsequent posting from Australia to Malaysia would be considered to arise in connection with the new employment with the UK company. The 52 week period would cease.
> Had the UK employer simply posted him to Malaysia in connection with the original occupation/employment as a General Manager then the 52 week period would have continued in full.

Whether or not this is actually right depends on the documentation relating to the contract of employment.

35.6 ROW: Residence requirements

Section 1(6) SSCBA provides:

> No person shall—
> (a) be liable to pay Class 1, Class 1A, Class 1B or Class 2 contributions unless he fulfils prescribed conditions as to residence or presence in Great Britain;
> (b) be entitled to pay Class 3 contributions unless he fulfils such conditions; or
> (c) be entitled to pay Class 1, Class 1A, Class 1B or Class 2 contributions other than those which he is liable to pay, except so far as he is permitted by regulations to pay them.

Reg. 145 SSCR provides five different sets of residence requirements. These apply in addition to the employed in GB rule.

35.6.1 *Primary Class 1 NIC*

Reg. 145(1)(a) SSCR provides that the requirement is:

> as respects liability of an employed earner to pay primary Class 1 contributions in respect of earnings for an employed earner's employment, that the employed earner is resident or present in Great Britain or Northern Ireland (or but for any temporary absence would be present in Great Britain or Northern Ireland) at the time of that employment or is then ordinarily resident in Great Britain or Northern Ireland (as the case may be).

There are four possible territorial connections, and if any one of them is satisfied Primary Class 1 NIC is in principle payable:

(1) Residence in UK.
(2) Presence in UK.
(3) Temporary absence from UK.
(4) Ordinary residence in UK.

Tax Bulletin 79 explains:

> The effect of Regulation 145 (1) SSCR 2001 is to provide for a kind of constructive presence for periods outside the UK which are merely a "temporary absence". This concept of temporary absence requires that:
> i. the person's absence be temporary,
> ii. that if he were not absent he would be present in the UK.
>
> This means that an employee who has employment based in the UK who goes abroad for a time on a short business trip or holiday abroad, and who departs from or returns to the UK, can continue to be within the UK scheme.
>
> An example of this would be the person who flies to a board meeting outside the UK and then returns to their UK based employment.

That seems obvious. The Bulletin continues:

> Taken together, Section 2(1)(a) SSCBA 1992 and Regulation 145 (1)(a) SSCR 2001 is enough to keep a person within Class 1 NIC if their employment is based here and their absence abroad is of a temporary or incidental nature. However, crucially, an employee who is not ordinarily resident in the UK and who normally works overseas cannot be said to be merely "temporarily absent" from employed earners employment in the UK if they are departing overseas for a time, to work for their foreign employer. In such a situation, the person is not performing duties which is merely incidental to the employed earner's employment in the UK but is returning to an employment based outside the UK. In the absence of an express contractual provision as to the attribution of the earnings, the earnings must be apportioned between the employed earner employment in the UK and the overseas duties for the foreign employer.

35.6.2 *First year in UK exemption*

Reg. 145(2) SSCR provides an exception:

> Where a person is ordinarily neither resident nor employed in the United Kingdom and, in pursuance of employment which is mainly employment outside the United Kingdom by an employer whose place of business is outside the United Kingdom (whether or not he also has a place of business in the United Kingdom) that person is employed for a time in Great Britain or Northern Ireland (as the case may be) as an employed earner and, but for the provisions of this paragraph, the provisions of sub-para (a) of para (1) would apply, the conditions prescribed in that sub-paragraph and in sub-para (b) of that paragraph shall apply subject to the proviso that—
> (a) no primary or secondary Class 1 contribution shall be payable in respect of the earnings of the employed earner for such employment;
> (b) no Class 1A contribution shall be payable in respect of something which is made available to the employed earner or to a member of his family or household by reason of such employment; and
> (c) no Class 1B contribution shall be payable in respect of any PAYE settlement agreement in connection with such employment,[8]
>
> after the date of the earner's last entry into Great Britain or Northern Ireland (as the case may be) and before he has been resident in Great Britain or Northern Ireland (as the case may be) for a continuous period of 52 contribution weeks from the beginning of the contribution week following that in which that date falls.

Thus employment in the UK is not subject to NIC for 52 weeks provided the following conditions are satisfied:

(1) employee not ordinarily resident in UK;
(2) employee not ordinarily employed in UK;
(3) employment mainly outside the UK;

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8 I have corrected a disastrous typographical error in the SSCR by inserting a paragraph break here. The last paragraph (beginning "after the date") governs paras (a), (b) and (c). This can be seen to be correct from context and by comparing the predecessor, reg.119(2) SSCR 1979.

(4) employer has a place of business outside the UK.[9]

NI Manual provides at para 33023 [November 2005]:

> The exemption lasts until the employee has been resident in GB for a continuous period of 52 weeks starting from the beginning of the contribution week following the week in which the worker arrives in GB to take up employment.
>
> A further 52 week period may commence where an employee returns to the overseas employment and then commences a new secondment in GB.
>
> The exemption does not apply to:
>
> - EEA nationals as this would contravene the principle behind 1408/71 see NIM33005
> - RA countries where a person is treated as being ordinarily resident in the UK if they fall within UK domestic legislation see NIM33015
> - Employees who intend to work in GB for 3 years or more at the outset. Such employees will be treated as being ordinarily resident.[10]
> - To decide whether a person coming to the UK is ordinarily resident in the UK for NIC purposes, apply the tests suggested in NIM33031 and NIM33032.
>
> **33024.**
>
> **ROW - Exemption example**
>
> A doctor works for a hospital in Egypt as a surgeon and sees an advert in a medical journal for surgeons position in Newcastle for a 2 year period. The position will enable him to obtain further advanced surgical qualifications.
>
> He applies and is successful. The Egyptian employer agrees to keep his employment position open until he returns. The doctor signs a contract of employment with the hospital in Newcastle for two years.
>
> In this case the 52 week exemption tests are satisfied. He is not ordinarily resident or employed in GB. He is employed for a time in GB as an employed earner. A major indicator in this example is the continuing employment in Egypt and the employee being able to return after the period of employment in GB.

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9 It might be inferred that the relief only applies if the employer's principal place of business is outside the UK, but the better view is that any place of business outside the UK is sufficient, and this is consistent with reg.146(2).

10 [Author's Note] I have retained this sub-paragraph which was deleted (I think accidentally) in early 2006.

> In order to satisfy the "in pursuance of employment" test the employment in GB must be related to the particular employment that the employee has outside of GB. The fact that the employee may be pursuing their own goals is not relevant. It is characteristic of much skilled work that the employer's interests in a person's improved skills will coincide with the employee's interest in advancing their career and marketability. Provided that the facts support that the employment in GB and obtaining of advanced qualifications (in this case advanced surgical qualifications) are required for the employment abroad then the test may apply
> A different conclusion may have been reached if the employment and qualifications obtained in GB were diverse from the employment in Egypt.

35.6.3 *Student exemption*

Reg. 145(3) SSCR provides an exception for students and apprentices:

> Where a person to whom para (1)(a) would otherwise apply is not ordinarily resident in the United Kingdom and is not a person to whom the provisions of para (2) apply, the proviso in para (2) shall nevertheless apply if either—
> (a) during a vacation occurring in a course of full-time studies which that person is pursing [*sic*] outside the United Kingdom, that person is gainfully employed under a contract of service in Great Britain or Northern Ireland (as the case may be) in temporary employment of a nature similar or related to that course of studies; or
> (b) there exists between him and some other person outside the United Kingdom a relationship comparable with the relationship between an apprentice and his master in Great Britain or Northern Ireland (as the case may be) and that person is gainfully employed under a contract of service in Great Britain or Northern Ireland (as the case may be) in employment which began before he attained the age of 25 and which is of a nature similar or related to the employment under the said relationship outside the United Kingdom.

35.6.4 *Secondary Class 1, Class 1A and 1B NICs*

Reg. 145(1)(b) SSCR provides that the requirement is:

as respect[11] liability to pay secondary Class 1 contributions, Class 1A contributions or Class 1B contributions that the person who, but for any conditions as to residence or presence in Great Britain or Northern Ireland (as the case may be and including the having of a place of business in Great Britain or Northern Ireland),[12] would be the secondary contributor or the person liable for the payment of Class 1B contributions (in this Case referred to as "the employer") is resident or present in Great Britain or Northern Ireland when such contributions become payable or then has a place of business in Great Britain or Northern Ireland (as the case may be), so however that nothing in this paragraph shall prevent the employer paying the said contributions if he so wishes.

Thus there are three possible connecting factors and if any of them is satisfied, secondary Class 1 NIC is due:

(1) employer is resident in UK;
(2) employer is present in UK;
(3) employer has a place of business in UK.

The first year in UK and student exemptions may apply.

35.7 Primary and Secondary Class 1 NIC: HMRC examples

Tax Bulletin 79 provides:

Example 1
Resident/Not Ordinarily Resident UK - Sent from ROW country to work in the UK - contractual employer in ROW country but seconded to the UK "host" employer.
An Australian employer assigns Angus, who normally works in Australia to the United Kingdom for 2 years. Residence status is resident in the UK

11 This is a slip for "*as respects*" … but nothing turns on that.

12 The long phrase beginning "but for" (and continuing to the close of brackets which follows) appears to be otiose. The paragraph means:

> "as respects liability to pay secondary Class 1 contributions, Class 1A contributions or Class 1B contributions that the person who is the secondary contributor or the person liable for the payment of Class 1B contributions (in this Case referred to as "the employer") is resident or present in Great Britain or Northern Ireland when such contributions become payable or then has a place of business in Great Britain or Northern Ireland …"

but not ordinarily resident in years 1 and 2.

Angus meets the criteria for a 52 weeks exemption from NIC because he is not ordinarily resident in the UK and he is not ordinarily employed in the UK and is working for his overseas employer and is in the UK in continuance of that employment. His Australian employer has no place of business in the UK.

Once the first 52 weeks period in Regulation 145(2) SSCR 2001 has expired, Angus will become liable for contributions in the UK. As his contractual employer has no place of business in the UK, the UK "host" employer to whom personal service is made available is the secondary contributor - liable for the employer part of the National Insurance. [Para 9 to Regulation 3, Social Security Categorisation of Earners Regulations 1978].

When he is in the UK, Angus is in employed earner's employment and meets the residence criteria in Regulation 145 (1) SSCR 2001 because he is present in the UK at the time of his employment.

Angus makes a short trip back to Australia in year 2 to brief the Australian company.

After 14 months in the UK, Angus returns to Australia for the month of June - 20 days holiday and 5 days working for the Australian company. He then returns to the UK to complete the rest of his assignment. Angus remains under contract to the Australian company and the costs of his employment in the UK is met by the Australian employer. There is no apportionment of salary specified in the contract. There can be apportionment of his salary for the days working outside the UK.

When Angus is in earners employment in the UK he is liable for NICs on his salary because he meets the criteria of residence and presence in Regulation 145 (1) SSCR 2001.

When in Australia, Angus is not in employed earners employment in the UK - his employment is one which is normally based outside the UK - so that the days working in Australia are not an incidental part of employed earners employment in the UK.

What if the employment had been funded by the UK company?

We would consider this a strong indicator that Angus was performing his duties in Australia for the purposes of the business of the UK "host" employer and his time in Australia was merely a "temporary absence" from employed earner's employment for the purposes of Regulation 145(1) SSCR 2001.

What if there is a letter of secondment - attaching Angus to his UK employer?

We consider that this would be a strong indicator that Angus's normal base is the UK and he can be considered to be merely "temporarily absent" for the purposes of Regulation 145(1) SSCR 2001 - the duties in Australia are incidental to the employment in the UK for which he is paid his salary.

What if Angus had travelled to China for 3 days to act on behalf of the UK company?

Angus's normal base is the UK and he can be considered to be merely "temporarily absent" for the purposes of Regulation 145(1) SSCR 2001 - the duties in China are incidental to the employment in the UK. No apportionment is required.

What if Angus had travelled to China for 3 days to act on behalf of the

Australian company?

The duties are not further to the employment in the UK and cannot be regarded as merely a temporary absence. An apportionment is required.

What if Angus has been sent to the UK and become ordinarily resident here?

If Angus's normal base is the UK he will be in employed earner's employment in Great Britain. As he is ordinarily resident he meets the residence criteria in Regulation 145(1) SSCR 2001 - the duties in Australia are merely incidental to the employment in the employed earner's employment in the UK for which he is paid his salary. No apportionment is required.

Exactly how many days amounts to a "temporary absence"?

Whether an absence is a temporary absence is a question of fact and degree, which depends upon the nature of the circumstances. Examples of what we would consider to be temporary absence would include short business trips or holidays.

Method of Time Apportionment

In the absence of contractual provision, there is to be an apportionment between UK and non-UK workdays under Section 2 of the Apportionment Act 1870. Under the Apportionment Act, salary accrues on a daily basis. The earnings are to be multiplied by a fraction where the numerator is the number of days working overseas in the overseas employer's business and the denominator is the total number of days in employment – in a full year this will be 365 days.

Where the employee is monthly or weekly paid, the computation has to take account of the "pay period" basis for computing NIC.

Example 2

Mrs Patel is ordinarily resident in India and is sent to the UK by her employer to work in the UK at the offices of a UK company which is part of the group. She remains under contract to the Indian employer and the Indian employer bears the cost of the employment. Her salary is £100,000. Her employer recalls her to India to advise on a hostile take-over for a period of 5 days - From 1 June until 5 June. The substantial part of 2 of those days is spent flying to India and back.

The earnings are multiplied by a fraction where the numerator is the number of days working overseas in the overseas employer's business and the denominator is the total number of days in employment.

If Mrs Patel has an annual pay period, then the appropriate fraction can simply be applied to her annual salary.

Gross Pay £100,000 x 5/365

Amount attributable to overseas workdays less £1369.87

NIC is operated on the gross pay attributable to the UK £98,630.13

However, if Mrs Patel is monthly paid, the employer has to account for NIC each month as a payment is made, and is unable to "look back" over a year and know what percentage needs to be applied. So the apportionment has to be done in the monthly pay period.

In June, no NICs are due on the salary paid in respect of the work in India.

The earnings on which NICs are to be calculated are those for the month of June – after an apportionment to take account of the 5 days which were not in respect of the employed earners employment.

Monthly salary £8333.33 x 5/365 x 100,000 less £1369.87
Amount attributable to non-UK workdays £1369.87
NIC is operated on the monthly gross pay attributable to the UK **£6963.46**

Holidays

If Mrs Patel were to take a holiday in India, the holiday may need to be brought into the calculation of non-UK workdays in the apportionment – depending on the contractual provisions and whether the holiday is attributable to the UK or overseas employment.

In Example 2, if in June Mrs Patel took 10 days holiday in India – in the absence of contractual provisions setting out how holiday accrues, these would be added to the 5 days working in India:

Salary £8333.33 x 15/365 x £100,000
amount attributable to non-UK workdays = £4109.59
Earnings in the Month on which NIC must be operated = £4223.74

What about part of a day worked in the UK and part overseas?

We operate the practice in SP 5/84 with regard to days spent working partly in the UK and partly outside the UK. That is to say, if a day is substantially worked overseas for the overseas business then it will count as a non-UK work day in the apportionment computation. Where an employee spends a whole day working in the UK but then leaves the country that evening on an overseas business trip, it would be difficult to say as a matter of contract that the employee's emoluments for that day were not attributable on a time apportionment basis to duties performed in the UK. It follows that the emoluments for a day spent working overseas before returning to the UK in the evening will be attributable to duties performed overseas.

Records

Employees are required to retain evidence such as travel documents and business diaries to demonstrate how they have calculated non-UK workdays for tax. Where records of "non-UK workdays" for tax have been kept, these may be used as the basis for identifying non-UK days for National Insurance.

35.8 ROW: Class 2 NIC

Reg. 145(1)(c) (d) SSCR provide that the requirements are:

(c) as respects entitlement of a self-employed earner to pay Class 2 contributions, that that earner is present in Great Britain or Northern Ireland (as the case may be) in the contribution week for which the contribution is to be paid;

(d) as respects liability of a self-employed earner to pay Class 2 contributions, that the self-employed earner is ordinarily resident in Great Britain or Northern Ireland (as the case may be), or, if he is not so ordinarily resident, that before the period in respect of which any such contributions are to be paid he has been resident in Great

> Britain [or Northern Ireland][13] (as the case may be) for a period of at least 26 out of the immediately preceding 52 contribution weeks under the Act, the Social Security Act 1975 or the National Insurance Act 1965 or under some or all of those Acts.

Thus there are two possible connecting factors and if either is present, Class 2 NIC is due:

(1) ordinary residence in UK;
(2) residence for 26 out of 52 contribution weeks.

35.9 ROW: Class 3 NIC

Reg. 145(1)(e) SSCR provides that the requirement is:

> as respects entitlement of a person to pay Class 3 contributions in respect of any year, either that—
> (i) that person is resident in Great Britain or Northern Ireland (as the case may be) throughout the year,
> (ii) that person has arrived in Great Britain or Northern Ireland (as the case may be) during that year and has been or is liable to pay Class 1 or Class 2 contributions in respect of an earlier period during that year,
> (iii) that person has arrived in Great Britain or Northern Ireland (as the case may be) during that year and was either ordinarily resident in Great Britain or Northern Ireland (as the case may be) throughout the whole of that year or became ordinarily resident during the course of it, or
> (iv)that person not being ordinarily resident in Great Britain or Northern Ireland (as the case may be), has arrived in that year or the previous year and has been continuously present in Great Britain or Northern Ireland (as the case may be) for 26 complete contribution weeks, entitlement where the arrival has been in the previous year arising in respect only of the next year.

13 These words omitted (presumably accidentally) from the SSCR but the context requires them.

35.10 Place of business in UK

Tax Bulletin 49 provides:

> **Place of business in UK**
> We would normally accept as a strong indication that there is a place of business in the UK if a company is registered under the Companies Act 1985.[14] But whether there is a place of business in the UK is a question of fact based on the individual case. Case law has shown that a company establishes a place of business in the UK if it carries on part of its business here. Such business activity need not be either a substantial part of, or more than incidental to, its main objects (*South India Shipping Corporation Ltd v Export-Import Bank of Korea* [1985] 2 AER 219). However there must be a more or less permanent location, not necessarily owned or leased by the company but associated with the company, from which its business is conducted habitually or with some degree of regularity (*Re Oriel Ltd* [1985] 3 AER 216). In Canadian law the premises of a group company are not sufficient in themselves to be a place of business for another group member (*Imperial Oil v Oil Workers International* 69 WWR 702).
> We would not seek to claim in isolation that there is a place of business where the overseas provider legally, and in exchange for a payment commensurate with the service, sub-contracts services to a UK business.

35.11 Residence and ordinary residence

The NIC legislation does not define residence or ordinary residence. For residence, the NI Manual states at para 29009:

> You should operate Residence Manual[15] guidance in deciding whether a person is domiciled or resident. Any difficulties on residence should be submitted to CNR [Centre for Non-Residents].

So the IT rules are applied.

For ordinary residence, the NI Manual states at para 33032:

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14 [Author's Note] Section 692 Companies Act 1985 imposes a registration duty on a foreign incorporated company which establishes a place of business in GB and Northern Ireland has equivalent legislation.

15 This is presumably a reference to the HMRC Residence Guide.

In considering whether a person is "ordinarily resident", you should:

- take into account the following factors
- in order to build up an overall picture of the person's position.

Factor	**Indication**
1. Will the person be returning to Great Britain or Northern Ireland during the period of employment abroad?	**Yes** – indicates ordinary residence continues during the period(s) abroad, especially the more frequent or longer the return visits. **No** – indicates the person ceasing to be ordinarily resident.
2. What will be the purpose(s) of the return visit(s)?	Visit(s): to see family who have remained at the person's home in Great Britain or Northern Ireland; and/or as holidays spent at the home, indicate ordinary residence. If the visit(s) is in connection with the employment abroad, for instance, training, this is not such a strong indication of ordinary residence.
3. Will the person's family – spouse/partner and/or children – be going abroad as well?	**Yes** – indicates that the person is no longer ordinarily resident, especially if they do not maintain a home in Great Britain or Northern Ireland (see factor 4). **No** – indicates ordinary residence continuing during period(s) abroad.
4. Will the person retain a home in Great Britain or Northern Ireland during their period abroad?	**Yes** – indicates ordinary residence continuing during period(s) abroad. **No** – indicates that the person is less likely to remain ordinarily resident.
5. If the person retains a home, will it be available for their use when they return?	**Yes** – indicates ordinary residence continuing during period(s) abroad. **No** – because, for instance, it is let on a long lease, then it is less likely that the person will remain ordinarily resident.
6. Will the person be returning to Great Britain or Northern Ireland at the end of the period abroad?	**Yes** – indicates ordinary residence continuing during period(s) abroad. **No** – indicates that the person is no longer ordinarily resident, especially if they do not retain a home in Great Britain or Northern

	Ireland during their absence abroad (see factor 4 above).
7. How long has the person lived in Great Britain or Northern Ireland?	The longer the period, the stronger the indication that the person is ordinarily resident.

For guidance on the definition of "ordinarily resident" for tax purposes, see the Residence Manual.

The seven factors are unhelpful, firstly as no guidance is given how to deal with the practical problems when different factors point in different directions, and secondly because the reader who turns (as directed) to the "Residence Manual"[16] will find completely different (and somewhat more usable) guidance. It is suggested that the IT principles should be applied.

35.12 Council Regulation 1408/71

The position within the EU is regulated by Council Regulation of 14 June 1971 "on the application of social security schemes to employed persons, to self-employed persons and to members of their families moving within the Community". EU regulations do not have short titles (which were introduced in the UK in 1845) so this is here called "Regulation 1408/71".

35.13 Persons covered by Regulation 1408/71

Article 2 of Regulation 1408/71 provides:

> 1. This Regulation shall apply to employed or self-employed persons and to students who are or have been subject to the legislation of one or more Member States and who are nationals of one of the Member States or who are stateless persons or refugees residing within the territory of one of the Member States, as well as to the members of their families and their survivors.

This paragraph almost waddles in its loosely attached subsidiary clauses, a classic cause of ambiguity. It is suggested that the correct meaning is:

16 This is presumably a reference to the HMRC Residence Guide.

> This Regulation shall apply to
> [1] employed or self-employed persons and to students
> [2] who are or have been
>   [i] subject to the legislation of one or more Member States and
>   [ii] who are:
>   [A] nationals of one of the Member States or
>   [B] who are stateless persons or refugees residing within the territory of one of the Member States,
>
> as well as to the members of their families and their survivors.[17]

35.14 EEA: Tie-breaker rules

Article 13(1) sets out the principle of a tie-breaker rule:

> Subject to Articles 14c and 14f, persons to whom this Regulation applies shall be subject to the legislation of a single Member State only. That legislation shall be determined in accordance with the provisions of this Title.

35.14.1 *Place of employment rule*

Article 13(2) of Regulation 1408/71 provides a place of employment rule for employees and self-employed:

> Subject to Articles 14 to 17:
> (a) a person employed in the territory of one Member State shall be subject to the legislation of that State even if he resides in the territory of another Member State or if the registered office or place of business of the undertaking or individual employing him is situated in the territory of another Member State;
> (b) a person who is self-employed in the territory of one Member State shall be subject to the legislation of that State even if he resides in the territory of another Member State. …

Article 13(f) sets out a default rule if these rules fail, but it is hard to see how this could apply in the UK. Perhaps it is relevant in some other

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17 In the UK, NICs (other than the voluntary Class 3 NIC) are only paid by employed or self-employed, so the reference to “members of their families and their survivors” is otiose; but it may be relevant elsewhere in the EU.

countries:

> a person to whom the legislation of a Member State ceases to be applicable, without the legislation of another Member State becoming applicable to him in accordance with one of the rules laid down in the aforegoing subparagraphs or in accordance with one of the exceptions or special provisions laid down in Articles 14 to 17 shall be subject to the legislation of the Member State in whose territory he resides[18] in accordance with the provisions of that legislation alone.

35.14.2 *Year abroad rule for employees*

Article 14(1) of Regulation 1408/71 provides a rough equivalent of the year abroad rule for employees:

> **14 Special rules applicable to persons, other than mariners, engaged in paid employment**
> Article 13(2)(a) shall apply subject to the following exceptions and circumstances:
> 1.
> (a) A person employed in the territory of a Member State by an undertaking to which he is normally attached who is posted by that undertaking to the territory of another Member State to perform work there for that undertaking shall continue to be subject to the legislation of the first Member State, provided that
> [i] the anticipated duration of that work does not exceed 12 months and that
> [ii] he is not sent to replace another person who has completed his term of posting;

Conditions [i] and [ii] make this a more restricted exemption than the SSCBA rules. The procedure is explained in NI Manual para 33008:

> **Article 11 of Council Regulation (EEC) No 574/72**
> Where Article 14.1(a) applies form E101 can be obtained. This form confirms to the authorities in the host Member State that contributions continue to be paid in the home State and will prevent a demand from that State for Social Security contributions to their scheme. Form E101

18 "Residence" is defined to mean habitual residence: Art.1(h).

> is obtained by the employer on behalf of the employee from the home Social Security authorities prior to posting and is valid for up to 12 months.
> Form E101 applications in the UK are administered by Centre For Non-Residents (Newcastle)

Article 13(2) continues:

> (b) if the duration of the work to be done extends beyond the duration originally anticipated, owing to unforeseeable circumstances, and exceeds 12 months, the legislation of the first Member State shall continue to apply until the completion of such work, provided that the competent authority of the Member State in whose territory the person concerned is posted or the body designated by that authority gives its consent; such consent must be requested before the end of the initial 12-month period. Such consent cannot, however, be given for a period exceeding 12 months.

The procedure is explained in NI Manual para 33009:

> **EEA Extensions [October 2005]**
> **Article 14.1(b) 1408/71**
> If due to unforeseeable circumstances the period of employment abroad unexpectedly lasts longer than the anticipated period and extends beyond 12 months the legislation of the home Member State can continue to apply for a further 12 months. The employer must complete form E102 (for UK cases Centre For Non-Residents (Newcastle)) before the end of the first 12 months and send it to the Social Security authorities in the host State see NIM33010
> **33010. EEA Form E102**
> Article 11 of Council Regulation (EEC) No 574/72
> The employer in the home State must apply on Form E102 to the Social Security authorities in the country of employment. The authorities in the country of employment will decide whether the request can be granted. The foreign authority will return form E102. If an extension is refused the employee is subject to the legislation of the host State from the date of expiry of the form E101.

35.14.3 *Two places of employment*

The place of employment rule cannot act as a tie-breaker if there are two places of employment. In this case Art.14(2) provides:

> A person normally employed in the territory of two or more Member States shall be subjected to the legislation determined as follows:
> (a) [this concerns travelling or flying personnel of international transport undertakings]
> (b) a person other than that referred to in (a) shall be subject:
> (i) to the legislation of the Member State in whose territory he resides,[19] if he pursues his activity partly in that territory or if he is attached to several undertakings or several employers who have their registered offices or places of business in the territory of different Member States;
> (ii) to the legislation of the Member State in whose territory is situated the registered office or place of business of the undertaking or individual employing him, if he does not reside in the territory of any of the Member States where he is pursuing his activity.
> (3) A person who is employed in the territory of one Member State by an undertaking which has its registered office or place of business in the territory of another Member State and which straddles the common frontier of these States shall be subject to the legislation of the Member State in whose territory the undertaking has its registered office or place of business.

35.15 EEA: Self-employed rules

35.15.1 *Year abroad rule for self-employed*

Article 14a of Regulation 1408/71 provides a year abroad rule for the self-employed:

> **Special rules applicable to persons, other than mariners, who are self-employed**
> Article 13(2)(b) shall apply subject to the following exceptions and circumstances:
> (1)
> (a) A person normally self-employed in the territory of a Member State and who performs work in the territory of another Member State shall continue to be subject to the legislation of

19 "Residence" is defined to mean habitual residence: Art.1(h).

the first Member State, provided that the anticipated duration of that work does not exceed 12 months;

(b) if the duration of the work to be done extends beyond the duration originally anticipated, owing to unforeseeable circumstances, and exceeds 12 months, the legislation of the first Member State shall continue to apply until the completion of such work, provided that the competent authority of the Member State in whose territory the person concerned has entered to perform the work in question or the body appointed by that authority gives its consent; such consent must be requested before the end of the initial 12-month period. Such consent cannot, however, be given for a period exceeding 12 months.

35.15.2 *Two places of self-employment*

The place of self-employment rule cannot act as a tie-breaker if there are two places of self-employment. In this case Art.14a(2) provides:

> A person normally self-employed in the territory of two or more the Member States shall be subject to the legislation of the Member State in whose territory he resides[20] if he pursues any part of his activity in the territory of the Member State. If he does not pursue any activity in the territory of the Member State in which he resides, he shall be subject to the legislation of the Member State in whose territory he pursues his main activity. The criteria used to determine the principal activity are laid down in the Regulation referred to in Art.98.
>
> (3) A person who is self-employed in an undertaking which has its registered office or place of business in the territory of one Member State and which straddles the common frontier of two Member States shall be subject to the legislation of the Member State in whose territory the undertaking has its registered office or place of business.
>
> (4) If the legislation to which a person should be subject in accordance with paras (2) or (3) does not enable that person, even on a voluntary basis, to join a pension scheme, the person concerned shall be subject to the legislation of the other Member State which would apply apart from these particular provisions or, should the legislations of two or more Member States apply in this way, he shall be subject to the legislation decided on by common agreement amongst the Member

20 "Residence" is defined to mean habitual residence: Art.1(h).

States concerned or their competent authorities.

Article 14c deals with persons simultaneously employed and self-employed, not discussed here.

Article 14d provides:

> (1) The person referred to in Article 14(2) and (3), Article 14a(2), (3) and (4), Article 14c(a) and Article 14e shall be treated, for the purposes of application of the legislation laid down in accordance with these provisions, as if he pursued all his professional activity or activities in the territory of the Member State concerned.
> (2) The person referred to in Article 14c(b) shall be treated, for the purposes of determining the rates of contributions to be charged to self-employed workers under the legislation of the Member State in whose territory he is self-employed, as if he pursued his paid employment in the territory of the Member State concerned.

35.16 Special cases by agreement

Article 17 provides:

> **17 Exceptions to Articles 13 to 16**
> Two or more Member States, the competent authorities of those States or the bodies designated by these authorities may by common agreement provide for exceptions to the provisions of Articles 13 to 16 in the interests of certain categories of persons or of certain persons.

The NI Manual para 33011 provides:

> **EEA – longer extension**
> **Article 17 of Council Regulation (EEC) No 1408/71**
> Where it is in the interest of the employee, Article 17 allows for two or more EEA countries to agree to an employee remaining insured in the home country for a longer period or to except any of the provisions in any of the insurability Articles in Regulation (EEC) 1408/71.
> It is possible for the employer to seek an extension to the normal time limits NIM33008 NIM33009 or where a posting may exceed the maximum period of cover from the outset. Usually a maximum period of 5 years can be agreed.
> NICO International Services deal exclusively with such requests. Form E101 will be held in Article 17 cases and issued by NICO International

Services

Posting more than 12 months from outset

A person is normally insurable under the Social Security scheme of the country of employment NIM33006 . However an employee sent to work in another EEA country on a long term posting (more than 12 months from the outset) can continue paying UK NICs if:

- the employee has specialist knowledge or skills in that job; or
- the employee has specific objectives in the other EEA country for which the employee's services are required; or
- it is in the employee's interest to remain UK insured

In such cases agreement must be obtained from the foreign authorities and the employee must provide a signed statement confirming they wish to continue contributing to the UK National Insurance scheme. Form E101 will be issued by International Services where UK NIC continues.

Article 17 not agreed

If the foreign authority does not agree the Article 17 request, the employee is subject to the legislation of the host State. No contributions are payable in the home State.

CHAPTER THIRTY SIX

CAPITAL GAINS OF INDIVIDUALS

36.1 Territorial scope of CGT

36.1.1 *"Chargeable" gains*

Section 15(2) TCGA provides:

> Every gain shall, except as otherwise expressly provided, be a chargeable gain.

The expression "chargeable" gain is a label which brings in an uncountable number of rules, for wherever the drafter wishes to provide a exemption, he typically provides that gains of the specified nature are not chargeable. However, the term "chargeable" gains does not bring in a territorial limitation. All gains are in principle "chargeable" gains regardless of residence or domicile of the person to whom the gains accrue.

36.1.2 *Territorial scope of CGT*

Section 2(1) TCGA provides:

> [1] Subject to any exceptions provided by this Act, and without prejudice to sections 10 and 276,
> [2] a person shall be chargeable to capital gains tax in respect of chargeable gains accruing to him in a year of assessment
>> [a] during any part of which he is resident in the UK, or
>> [b] during which he is ordinarily resident in the UK.

This provision refers to a "person" and so applies to individuals and trustees, personal representatives and companies (but companies are taken out of the scope of CGT by the Corporation Tax Acts).

In principle, therefore, a person who is neither resident nor ordinarily resident in the UK during a tax year is not within the charge to CGT. The expression "neither resident nor ordinarily resident" is clumsy and the case of someone who is ordinarily resident but not resident is very rare, maybe wholly theoretical. I generally abbreviate the expression to "non-resident" and leave "and not ordinarily resident" to be understood.

A non-resident person is in principle outside the scope of CGT regardless of domicile and regardless of the situs of the asset disposed of. (By contrast income tax is charged on UK source income, and IHT is charged on UK situate property, regardless of the residence of the individual.)

Section 2[1] TCGA refers to two exceptions to the general rule:

(1) A non-resident trader with a UK branch or agency.[1]
(2) Exploration and exploitation assets on the continental shelf (not discussed in this book).

A third, important, exemption concerns temporary non-residents.[2]

It follows that an individual (wherever domiciled) can in principle avoid CGT if he disposes of an asset in the tax year before he acquires the status of UK resident or ordinarily resident – or if he postpones the disposal until the tax year after he has lost that status. A simple form of CGT planning for an individual whose stay in the UK is a short-term one is not to dispose of assets giving rise to chargeable gains while UK resident.[3]

On years of arrival and departure see 6.16 (CGT on individuals).

36.2 CGT remittance basis

Section 12 TCGA provides:

> (1) This section applies to foreign chargeable gains accruing to an individual in a tax year ("the foreign chargeable gains") if—

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1 See 64.10 (Why does branch/agency matter?).

2 See 8.1 (Temporary non-residence). This is not technically an exception to the general rule, as the legislation does not impose a tax charge on gains accruing to a non-resident. It deems the gains to accrue later when the individual is resident. But it comes to the same thing.

3 See 6.20 (CGT planning – postponing disposals until non-resident).

(a) s. 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for that year, and

(b) the individual is not domiciled in the UK in that year.

(2) Chargeable gains are treated as accruing to the individual in any tax year in which any of the foreign chargeable gains are remitted to the UK.

(3) The amount of chargeable gains treated as accruing is equal to the full amount of the foreign chargeable gains so remitted in that year.

(4) In this section "foreign chargeable gains" means chargeable gains accruing from the disposal of an asset which is situated outside the UK.

(5) See Chapter A1 of Part 14 of ITA 2007 for the meaning of "remitted to the UK" etc."

The CGT remittance basis applies only to foreign domiciled individuals. (By contrast, the IT remittance basis also applies to individuals who are resident but not ordinarily resident.) The use of the word "individual" means that trustees and personal representatives do not qualify for the remittance basis.

The CGT remittance basis applies to foreign situate assets.[4] (By contrast, the RFI remittance basis applies to income from a foreign source, which is a different concept.)

There is no guidance on the position of an individual who changes domicile during a tax year. It might be logical if gains accruing during the non-domiciled part of the year qualify for the remittance basis but it is not possible to read s.12(1)(b) to give that result. Either the remittance basis applies for the whole year or for none of it. But in practice perhaps this rarely happens.

36.2.1 *Date of disposal under remittance basis*

The gain is treated as accruing in the tax year of remittance. By implication the gain is to be treated as not accruing on the date of the actual disposal, when it actually accrues. This is relevant to EIS reinvestment relief. The time limits for EIS relief depend on the time that the gain accrued (not the time that the disposal takes place).[5]

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4 See 60.1 (Situs of assets for CGT).

5 Para 1 Sch 5B TCGA 1992.

The time limits for rollover relief depend on the time of disposal.[6] The drafter of the former para 16(4) Schedule A1 TCGA clearly considered that the pre-2008 s.12(1)[e] TCGA altered the time of disposal so that the asset is regarded as disposed of at the time of remittance (not at the time of the actual disposal).[7]

36.3 Computation of gains in foreign currency[8]

The CG Manual provides:

> **CG25391 - Remittance basis: gains to be computed in Sterling**
> Sterling is the currency in which capital gains computations are carried out (see *Bentley v Pike,* (53 TC 590) and *Capcount Trading v Evans* (65 TC 545)). You should therefore carry out a computation of the gain arising on the disposal of the foreign assets in sterling. Where transactions take place in foreign currency you should convert each separate entry for the computation into sterling using the spot rate applying at the date that part of the transaction occurred.
> **CG25392 - accounts denominated in foreign currencies**
> To analyse an account at a specific date you must convert the figure of capital gain in sterling back into an amount of foreign currency using the spot rate of exchange at the date of the remittance. From the total balance in the account you can then deduct this figure and any amount of income held in the account to arrive at a net balancing figure. This balancing figure is normally called capital but when there have been movements in exchange rates it is not normally possible to reconcile it with the amount that was originally treated as capital in the foreign currency.
> *Example*
> Fatima is resident in the UK and claims the remittance basis in all relevant years. In August 2009 she disposes of property in Germany for net proceeds €400,000. She bought the property in March 2007 for €260,000. She banks the proceeds in a new account in Germany and in November 2010 transfers €100,000 from the account to a UK account denominated in Sterling. The Sterling: Euro exchange rates were

6 Section 152(3) TCGA 1992.
7 See the 6th edition of this book para 29.4.
8 See 10.53 (Translating foreign currency into sterling).

March 2007	0.571	
August 2009	0.909	
November 2010	0.966	

Foreign chargeable gain arising in August 2009:

Proceeds	£363,600	(400,000 x 0.909)
LESS cost	£148,460	(260,000 x 0.571)
Gain	£215,140	equivalent to €236,677 (215,140/0.909)

This gain is computed once and for all in Sterling at the time of the exchange, but as the foreign currency representing the gain is held in bank account there is the possibility that a further gain or loss will arise when there is a withdrawal from that account (TCGA92/S252, see CG78330).

As at August 2009 the bank account is a mixed fund containing foreign chargeable gains £215,140 (€236,677) and capital £148,461 (€163,323, ie €400,000 – €236,677).

By November 2010 this gain is equivalent to €222,712 (215,140/0.966) ie there is an unrealised foreign exchange loss of £13,490 (ie €(236,677-222,712) = €13,965 expressed in Sterling).

Under the mixed fund rules (see CG25385+) the amount transferred out of the mixed fund is treated as containing only foreign chargeable gains. The proportion of the gain remitted is the Sterling equivalent of the amount transferred as fraction of the total foreign chargeable gain: (100,000 x 0.966)/215,140 = 44.9%.

The same proportion of the loss due to exchange rate movements (ie 44.9% of £13,490) may be an allowable loss: see CG25330+ for information on losses under the remittance basis.

So the amount of the original gain remitted is £96,600 and, going forward, the mixed fund contains £118,540 foreign chargeable gain (£215,140 - £96,600), giving it an overall composition of €122,712 gains plus €177,288 capital (€300,000 total less the euro equivalent of the remaining gain)....

CG25430 - Disposal of assets situated abroad: Example 2

An individual resident but not domiciled in the UK has a foreign bank account in a foreign currency, F. The rate of exchange is 2F = £1 throughout this example. The account contains the following entries:

January 2009	Balance	Nil
January 2009	Deposit: sale of foreign shares A 8,000F in December 2005)	90,000F
February 2009	Withdrawal: purchase of foreign shares B	30,000F
March 2009	Withdrawal: brought to UK	30,000F

The gain arising is first calculated in sterling, thus:

		£
Proceeds	90,000F	45,000
less Cost	48,000F	24,000
	Foreign Chargeable Gain	21,000

Next, the account is analysed into capital and gains to give the composition of the balance of the account (90,000F – 30,000F = 60,000F) immediately before the March transfer, turning the gain back into foreign currency thus:

		Capital	**Capital Gain**	**Total**
January 2009	Deposit	48,000F	42,000F	90,000F
February 2009	Withdrawal to buy foreign shares	16,000F	14,000F	30,000F
	Balance	32,000F	28,000F	60,000F

The transfer of 30,000F is then split between capital and foreign chargeable gains according to the mixed fund rules (see CG25380+), so it is treated as containing 28,000F (£14,000) of gains and 2000F (£1000) capital. There is therefore a remittance of £14,000 of the gain on foreign shares A.

CG25431 - Disposal of asserts situated abroad: example 3

An individual, resident but not domiciled in the UK, has a foreign bank account in a foreign currency, F. The account contains the following entries:

November 2008	Balance	Nil
December 2008	Deposit – Partnership profits (relevant foreign income)	10,000F
	subject to foreign tax	
January 2009	Deposit – sale of shares	15,000F
	(cost 10,560F in December 1998)	
February 2009	Withdrawal – brought to UK	20,000F
The rate of exchange is	2.2F = £1 in December 1998	
	2.0F = £1 in December 2008 and January 2009	
	2.5F = £1 in February 2009	

As in Example 2, see CG25430, the capital gain on the shares is first computed in sterling by reference to the rates of exchange ruling at the dates of acquisition and disposal respectively: thus:

		£
	Disposal proceeds 15,000F ÷ 2.0	7,500
less	Cost 10,560F ÷ 2.2	4,800
	Foreign Chargeable Gain	2,700

Next, as in Example 2, we analyse the account. But this time we analyse it into income, capital and foreign chargeable gains.

Sterling is the only appropriate measure of capital gains ... We must therefore decide on the amount of capital gains in the account on the date the remittance is made by converting the sterling figures of gains back into the foreign currency at the rate of exchange applying at the remittance date (for example 2.5F = £1). So the £2,700 gains are represented by 6,750F at this date.

We then deduct the figures of foreign currency representing income and capital gains from the total foreign currency balance in the account. The figure we arrive at is normally called a figure of capital. However it is in reality only a balancing figure and it cannot be reconciled with amounts of capital that have been deposited in the account. Thus, in the present example:

	Income	Capital	Capital gains	Total
Deposit December 2008	10,000F			10,000F
Amount of Gains			6,750F	6,750F
Subtotal				16,750F
Figure of capital to balance		8,250F		8,250F
	10,000F	8,250F	6,750F	25,000F

The transfer of 20,000F is then matched with the contents of the mixed fund under the rules described in CG25380+:
£2,700 (6,750F) is foreign chargeable gains
£4,000 (10,000F) is relevant foreign income (partnership profits)
£1,300 (3,250F) is capital
The first two components are remittances taxable in the UK.

In computing CGT remittances the legislation requires unworkable computations in all but the simplest cases. HMRC have in the past taken a realistic approach. CG Manual para 25420 provided:

> ***Practical Approach***
> *Where there have been a large number of transactions in a bank account and sums have been traced through a number of investments and/or transfers between bank accounts it may[!] be very difficult to carry out the analysis necessary to arrive at the correct figure for assessment. Because of this you may adopt any method suggested by, or acceptable to, the taxpayer which seems likely to produce a reasonable approximation to the liability which would result from the strict application of the rules.*

This passage was quietly deleted 31 March 2009, but one hopes that HMRC practice has not changed.

36.4 Interaction of remittance basis and abolition of taper

Para 56 Sch 2 FA 2008 provides:

> (1) The amendments made by para 31(2) and (3) have effect where the intervening year is the tax year 2008-09 or any subsequent tax year.
> (2) The amendments made by paras 41 and 43 have effect where the eligible year is the tax year 2008-09 or any subsequent tax year.
> (3) The other amendments made by paras 23 to 55 have effect in relation to chargeable gains accruing or treated as accruing in the tax year 2008-09 or any subsequent tax year.

This removes taper and indexation relief on gains on disposals before 2008/09 which are remitted after 2008/09. All computations of gains pools made before 2008 will need to be recomputed.

CGT Draft Clauses FAQ provides:

> **Q. How will the gain be calculated for a non-domiciled individual with overseas assets if the gain arises in this tax year but is remitted next tax year?**
> A. A gain arising to a non-domiciled individual in the current tax year, 2007-08, will be calculated under the usual rules, and indexation allowance will be available where appropriate. But that gain is chargeable in the next tax year, 2008-09, because the individual remits the gain in that year. No taper relief will be available and the single 18 per cent CGT rate will apply.[9]

36.4.1 *Disposals before 2008/09: transitional rules*

Suppose an asset was disposed of before 2008/09 for £300 with an indexed and tapered gain of £100 and an unindexed and untapered gain of £200.

If all the £300 is remitted before 2008/09 then £100 is subject to CGT (at an effective 40% rate).

If all £300 is remitted after 2008/09 then £200 is subject to CGT (at the 18% rate).

What happens if (say) £150 is remitted before 2008/09 then £50 is subject to CGT at the then rate. If the remaining £150 is remitted after 2008/09 what happens? The one thing that is pretty certain is that the drafter did not ask himself this question.

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9 *www.hmrc.gov.uk/cgt/faqs-cgt-reform.htm* 24 January 2008 [2008] STI 171.

36.5 Liquidation of offshore company

Suppose:

(1) F (not UK domiciled) owns non-UK situate shares in a company, and
(2) the company is put into liquidation and F receives a distribution from the liquidator of the company.

F is treated as if he had disposed of the shares in consideration of the distribution: s.122 TCGA. The gain is taxable if the liquidator transfers to the shareholder money in the UK. The same applies if the liquidator transfers assets (land or chattels) enjoyed *in specie* here. It should normally be possible to avoid this.

36.6 CGT planning: making UK situate property non-UK situate

36.6.1 *Moveable assets in UK*

Moveable assets could in principle be moved offshore prior to a disposal. Consider whether an export licence is needed.

36.6.2 *Unincorporated UK business carried on by foreign domiciliary*

A business could be transferred to a foreign incorporated company under s.162 TCGA and shares later sold. Watch stamp duty. Even if the company were subsequently to become non-resident on emigration of shareholder/directors, no tax would arise except on growth in value since transfer to the company.

36.6.3 *Debts*

There are two ways to deal with a UK situate debt on a security. It may be possible to make the asset non-UK situate. It may be possible to make the asset a simple debt (not a debt on a security) so it falls within the relief given by s.251 TCGA. It is important to do this by varying the existing debt, and not by ending the existing debt and creating a new one.[10]

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10 See *Chitty on Contracts*, 29th ed, 2004 para 22-029 (Substituted contract).

36.7 Foreign currency and foreign currency bank accounts

The legislation deals separately with foreign currency bank accounts and foreign currency not in a bank account.

36.7.1 *Foreign currency bank account*

A bank account is a debt, and a chargeable gain does not usually arise from a debt: s.251 TCGA. But this relief is disapplied for foreign currency bank accounts. Section 252(1) TCGA provides:

> Subject to subsection (2) below, section 251(1) shall not apply to a debt owed by a bank which is not in sterling and which is represented by a sum standing to the credit of a person in an account in the bank.

This is affected by SP 10/84:

> **Foreign bank accounts**
> 1. At present, under TCGA 1992 s 252(1), direct transfers from one foreign bank account to another are treated as a disposal and an acquisition of assets for CGT purposes.

This is correct in law if the transfer is from one bank to another. If the transfer is from one account to another at the same bank, the question is whether the two accounts constitute two separate assets or one single asset, which will depend on the facts and documentation. But it only matters for foreign domiciliaries as SP 10/84 gives a concession for UK domiciliaries:

> 2. Except in relation to an account to which TCGA 1992 s 275(l) applies[11] (accounts held by non-domiciled individuals), a taxpayer may treat all bank accounts in his name containing a particular foreign currency as one account and disregard direct transfers among such accounts for CGT purposes. This practice once adopted must be applied to all future direct transfers among bank accounts in that taxpayer's name containing that particular foreign currency until such time as all

11 See 6.10 (Bank account).

debt represented in the bank accounts has been repaid to the taxpayer.

The CG Manual provides:

78330. Foreign currency bank accounts
When currency is deposited in a bank account there is, for CGT purposes, a disposal of the currency for its sterling value at that time. The deposit establishes a debt due by the bank to the depositor. Apart from the debt on a security a debt is not a chargeable asset in the hands of the original creditor, see CG53400+. But TCGA 1992, s.252 prevents that exemption from applying to a debt which is not in sterling and which represents a credit balance in a bank account. Such a debt is a chargeable asset and each withdrawal from the currency account is a (part) disposal of the debt for the sterling value of the currency obtained. The currency obtained on the withdrawal from the bank is acquired for a consideration equal to its sterling value and that amount is allowable in computing the gain or loss on the subsequent disposal of the currency. Foreign currency certificates of deposit in bearer form are not within TCGA 1992, s.252.
78332. Identification of disposals with acquisitions
Each bank account is a single asset for the purposes of TCGA 1992, s.104(1). See CG50500+ for further advice on the pooling rules generally. Provided the practice is followed consistently, you may accept that all bank accounts in the taxpayer's name containing a particular foreign currency represent one account. You therefore disregard direct transfers between such accounts for capital gains purposes both as a withdrawal and an acquisition. This practice does not apply to accounts held abroad by non-domiciled individuals to which TCGA 1992, s.275 (l) applies. See SP10/84.
78333.
There are often large numbers of transactions on bank accounts. It can be a formidable task to compute gains or losses on numerous withdrawals. Provided the practice is followed consistently and produces a reasonable overall result, you may accept that a net figure for deposits and withdrawals be computed for each calendar month or part month within a tax year or accounting period. To find the acquisition costs and disposal proceeds, each monthly deposit or withdrawal thus computed should be converted into sterling at the average rate of exchange for the month; any reasonable method of arriving at this average is acceptable, again provided it is followed consistently. Identification and indexation apply in the normal way for the purpose of computing the gains on the withdrawals.

NOTE. Indexation allowance for taxpayers within the charge to CGT has been frozen at April 1998, see CG17207. For details of the replacement provision, taper relief, see CG17895+.

36.7.2 *Foreign currency not in a bank account*

Foreign currency is an asset on which a gain may accrue. CG Manual para 78316 provides:

Identification of disposals with acquisitions
Currency is subject to the same rules of identification and pooling as unquoted shares and securities. See CG50500+.
If the taxpayer agrees, you may adopt a simplified method for computing gains or losses on currency acquired and disposed of in the course of buying and selling overseas investments. You may treat all disposals of any one currency, or "class" of currency, in the year of assessment or accounting period as a single disposal. You should compute the gain or loss by reference to the average price of the pool from which the currency derived.

In practice it would be unusual for a person to hold substantial foreign currency outside a bank account, except as trading receipts outside CGT, so this is not important.

36.7.3 *Foreign currency for personal expenditure*

There are two exemptions for foreign currency needed for personal expenditure abroad. These are not likely to affect remittance basis taxpayers, as gains on disposals of this kind are not likely to be remitted, but I mention them for completeness. Section 269 TCGA provides:

A gain shall not be a chargeable gain if accruing on the disposal by an individual of currency of any description acquired by him for the personal expenditure outside the UK of himself or his family or dependants (including expenditure on the provision or maintenance of any residence outside the UK).

Section 252(2) TCGA is the corresponding provision for bank accounts:

> Subsection (1) above shall not apply to a sum in an individual's bank account representing currency acquired by the holder for the personal expenditure outside the UK of himself or his family or dependants (including expenditure on the provision or maintenance of any residence outside the UK).

The CG Manual para 78331 provides:

> **Personal expenditure of individuals**
> TCGA 1992, s.252(1) does not apply to a sum in an INDIVIDUAL'S bank account representing currency acquired by the holder for the personal expenditure outside the UK of the holder or the holder's family or dependants. This includes expenditure on the provision or maintenance of any residence outside the UK. This provision is similar to TCGA 1992, s.269 and it should be interpreted in accordance with CG78315.

36.8 Structure for UK trading company

It is not ideal for a foreign domiciled individual to carry on trade through a UK incorporated company which he owns absolutely, as a disposal of that asset would give rise to CGT. If the foreign domiciliary does not want to go to the trouble and expense of using an offshore trust, what is the alternative? One possibility is to use a foreign incorporated UK resident company. The shares in the company will not be UK situate for CGT.[12] A possible drawback is that s.720 ITA may apply unless the motive defence can be used.[13] This may in fact be an advantage, because it allows distributions from the company to be made tax free. Thus the shareholder may be taxed as a sole trader but without NICs. However, if profits are to be retained in the company it is a disadvantage.

A possibility is to trade through a UK incorporated and resident trading company held by a UK resident but foreign incorporated holding company:

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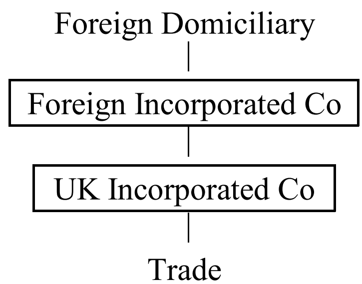
12 See 60.4 (Registered shares/debentures: non-UK company)

13 See 17.4.1 (Foreign incorporated company) and 21.34 (Transfer to UK resident foreign incorporated company).



The trading income will not be within the scope of s.720. The use of a holding company will not restrict small companies relief provided that it does not carry on a business. With a little care it can be arranged that a holding company does not carry on a business.[14]

36.9 UK resident trust

A UK resident trust is in principle subject to CGT even if the settlor is a foreign domiciliary. One might avoid this problem for the future by exporting the trust (appointing non-resident trustees) but there may in

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14 SP 5/94 provides:

(20 July 1994) Associated companies for small companies' relief and corporation tax starting rate: holding companies

Under TA 1988 s 13(4), a company which does not carry on any trade or business in an accounting period is disregarded in calculating the profits limits for the small companies' relief of any other company with which it is associated.

A holding company which does not carry on a trade, but which holds the shares in one or more companies which are its 51 per cent subsidiaries, may or may not be carrying on a business in respect of that holding. The Revenue's view is that a company is not carrying on such a business in an accounting period if, throughout that period, all of the following apply—

- it has no assets other than shares in companies which are its 51 per cent subsidiaries; and
- it is not entitled to a deduction, as charges or management expenses, in respect of any outgoings; and
- it has no income or gains other than dividends which it has distributed in full to its shareholders and which are, or could be, franked investment income received by that company (TA 1988 s 832(1), (4A)); and
- the 51 per cent subsidiaries are 51 per cent subsidiaries under TA 1988 s 247(8), (8A) and (9A), 13ZA(1)–(4).

principle be a migration charge.[15] This applies even if the assets are not situated in the UK. The remittance basis does not apply as that only applies to "individuals"; trustees are not individuals.

One solution may be to transfer assets from the trust to foreign domiciled beneficiaries absolutely. Although this involves a disposal by the trustees, it may be possible to claim CGT hold-over relief. The relief applies on a disposition to a UK resident foreign domiciled beneficiary, even though that beneficiary may later be able to dispose of the asset without a CGT charge.

15 See 6.4 (Exit charge for trusts).

CHAPTER THIRTY SEVEN

GAINS OF NON-RESIDENT TRUSTS: S.86

37.1 CGT on trusts – Introduction

A trust is in principle treated as a taxable unit. If the trustees are UK resident, they are in principle subject to CGT even if the beneficiaries have no connection with the UK. Non-resident trustees are not subject to CGT[1] even if their beneficiaries are resident in the UK. These rules present an obvious means of CGT avoidance. HMRC's first answer to this is the anti-avoidance rules in ss.86, 87 TCGA. In outline:

(1) If the settlor has an "interest in the settlement" (as widely and artificially defined) he will be liable to tax on gains accruing to the non-resident trustees. I refer to this as the "**s.86 charge**".
(2) UK resident beneficiaries of an offshore trust may be subject to tax if they receive capital payments from the trustees. I refer to this as the "**s.87 charge**".

A full discussion of these provisions requires a long book to itself. The discussion here is incomplete and focuses on the most common issues.

37.2 Fundamental s.86 conditions

Section 86(1) TCGA sets out five sets of conditions for s.86 to apply. I refer to these as "**the fundamental s.86 conditions**".

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1 See 33.1 (Territorial scope of CGT).

37.3 Qualifying settlement

Section 86(1) provides:

> This section applies where the following conditions are fulfilled as regards a settlement in a particular year of assessment—
> (a) the settlement is a qualifying settlement in the year;

"Qualifying settlement" is a label for a set of rules not discussed here. "Settlement" is not expressly defined here so the standard IT/CGT definition applies.

37.4 Trustee residence condition

The next s.86 condition is in s.86(1)(b):

> (b) the trustees of the settlement fulfil the condition as to residence;

This takes us to s.86(2) TCGA which provides:

> The condition as to residence is that—
> (a) the trustees are neither resident nor ordinarily resident in the UK during any part of the year, or
> (b) the trustees are resident and ordinarily resident in the UK during any part of the year, but at any time of such residence and ordinary residence they fall to be regarded for the purposes of any double taxation relief arrangements as resident in a territory outside the UK.

37.5 Settlor residence and domicile condition

The next s.86 condition is in s.86(1)(c):

> (c) a person who is a settlor in relation to the settlement ("the settlor"):
> [i] is domiciled in the UK at some time in the year and
> [ii] is either resident in the UK during any part of the year or ordinarily resident in the UK during the year;

Section 86 does not apply to a foreign domiciled settlor, whether or not he claims the remittance basis. This is a surprising inconsistency with the general scheme of the FA 2008. Where an individual does not wish to pay the £30,000 remittance basis charge, it may be worthwhile setting up an offshore trust to ensure that gains are taxed on a s.87 capital payment basis and not on an arising basis.

37.6 Settlor-interested condition

The next s.86 condition is in s.86(1)(d):

> (d) at any time during the year the settlor has an interest in the settlement;

The term "settlor-interested" in a s.86 context[2] is a label for a complex set of rules which are not discussed here.

If a settlement becomes (or ceases to be) settlor-interested, s.86 TCGA applies for the whole tax year, This is unlike the IT rules (where if a settlor is excluded s.624 ITTOIA ceases to apply from the date of the exclusion).[3] There is reason for the distinction, because the s.86 charge is on gains less losses for the entire year, and splitting the year would involve some trouble. The rule does however mean that CGT planning by excluding the settlor must be carried out well in advance.

37.7 Section 86 amount condition

The next s.86 condition is in s.86(1)(e):

> (e) by virtue of disposals of any of the settled property originating from the settlor, there is an amount on which the trustees would be chargeable to tax for the year under section 2(2) if the assumption as to residence specified in subsection (3) below were made.

This takes us to s.86(3) TCGA which provides:

> [a] Where subsection (2)(a) above[4] applies, the assumption as to residence is that the trustees are resident and ordinarily resident in the UK throughout the year; and

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2 The same term is used in an IT context with a different meaning: see 16.3.1 (The concept of "settlor-interested").

3 See 16.3.4 (Subsequent exclusion of settlor from the settlement).

4 See 37.4 (Trustee residence condition).

> [b] where subsection (2)(b) above applies, the assumption as to residence is that the double taxation relief arrangements do not apply.

I refer to this as the "**s.86 amount condition**".

The condition in s.86(1)(e) is merely that there is an amount, which I call "**the s.86 amount**". The quantum of the s.86 amount matters because the amount of the charge depends on that.

Para 1(1) Sch 5 provides:

> In construing section 86(1)(e) as regards a particular year of assessment, the effect of section 3 shall be ignored.

This disapplies the trustee annual exemption (which seems fair because the settlor has his own annual exemption).

37.8 Year of death of settlor

The next s.86 condition is in s.86(1)(f):

> Para 3, 4 or 5 does not prevent this section applying.

This sets out three conditions which are best considered separately.

Para 3 Sch 5 TCGA provides:

> Section 86 does not apply if the settlor dies in the year.

What is the reason for this rule? Perhaps it was thought unfair to tax the settlor's estate on post death gains, and too much trouble to split the year into disposals before/after the death.

37.9 Death or divorce of certain beneficiaries

The last two s.86 conditions are set out in paras 4 and 5 Sch 5 TCGA:

> 4(1)This paragraph applies where for the purposes of section 86(1)(d) the settlor has no interest in the settlement at any time in the year except for one of the following reasons, namely, that—
>
> (a) property is, or will or may become, applicable for the benefit of or

payable to one of the persons falling within para 2(3)(b) to [(db)] above,

(b) income is, or will or may become, applicable for the benefit of or payable to one of those persons, or

(c) one of those persons enjoys a benefit from property or income.

(2) This paragraph also applies where sub-para (1) above is fulfilled by virtue of 2 or all of paras (a) to (c) being satisfied by reference to the same person.

(3) Where this paragraph applies, section 86 does not apply if the person concerned dies in the year.

(4) In a case where—

(a) this paragraph applies, and

(b) the person concerned falls within para 2(3)(b), (d) or (db) above,

section 86 does not apply if during the year the person concerned ceases to be married to, or a civil partner of, the settlor, child or grandchild concerned (as the case may be).

5 (1) This paragraph applies where for the purposes of section 86(1)(d) the settlor has no interest in the settlement at any time in the year except for the reason that there are 2 or more persons, each of whom—

(a) falls within para 2(3)(b) to (db) above, and

(b) stands to gain for the reason stated in sub-para (2) below.

(2) The reason is that—

(a) property is, or will or may become, applicable for his benefit or payable to him,

(b) income is, or will or may become, applicable for his benefit or payable to him,

(c) he enjoys a benefit from property or income, or

(d) 2 or all of paras (a) to (c) above apply in his case.

(3) Where this paragraph applies, section 86 does not apply if each of the persons concerned dies in the year.

I cannot see the point of this, though it does offer a kind of symmetry with para 3. I rather doubt if it ever has applied or ever will apply.

37.10 Application of s.86

Assuming all eight fundamental s.86 conditions are satisfied, we proceed to s.86(4) TCGA which provides:

Where this section applies—

(a) chargeable gains of an amount equal to that referred to in subsection (1)(e) above shall be treated as accruing to the settlor in the year, ...

37.11 Interaction of s.86 and s.13 TCGA

Suppose a settlor-interested trust within s.86 TCGA owns a non-resident company within s.13 TCGA, and a gain accrues to the company. The gain is treated as accruing to the trustees. In the absence of express provision, this gain would not fall within s.86 because the s.86 amount condition would not be satisfied: the gain does not accrue "by virtue of disposals of any of the settled property".[5] The company property is not settled property. Para 1(3) Sch 5 TCGA deals with this:

> In a case where—
> (a) the trustees are participators in a company in respect of property which originates from the settlor, and
> (b) under section 13 gains or losses would be treated as accruing to the trustees in a particular year of assessment by virtue of so much of their interest as participators as arises from that property if the assumption as to residence specified in section 86(3) were made,
>
> the gains or losses shall be taken into account in construing section 86(1)(e) as regards that year as if they had accrued by virtue of disposals of settled property originating from the settlor.

37.12 Two settlors for CGT s.86 charge

The s.86 charge only applies to disposals of settled property "originating from the settlor". This expression is defined in TCGA Sch 5 para 8: see 58.3.6 (CGT s.86 definition of "settlor").

37.12.1 *Two direct settlors: A adds property to B's trust*

The position is straightforward if one individual ("A") creates a trust and another ("B") adds property to it. A and B are both settlors. If A is UK resident and B is non-resident, then A is not subject to CGT under s.86 and B is subject to tax on gains from the funds he provided.

The same applies if B adds value indirectly to A's trust (e.g. by a gift to a company held by the trust). B is a "settlor" for s.86 purposes: see 58.14 (Provision of property for company held by trust). A "just apportionment" is practical, though it may not be easy.

5 See 37.7 (Section 86 amount condition).

The CG Manual contains the following unexceptionable guidance:

> **34894. Multiple settlors** [August 2007]
> If IR Trusts Head Office Bootle or Financial Intermediaries and Claims Office (formerly Claims Branch) have given advice on apportionment for Income Tax purposes, this should be followed for CGT. Otherwise, if settlors together make the settlement, the gains in such a case should be apportioned according to the amounts each put in. If a settlor adds to a settlement, then the amount put in should be compared with the value of the settlement at that time. Trust Offices should endeavour to reach a fair and easily worked solution.[6]

37.12.2 *Direct and indirect settlors*

The position is less clear where there is an arrangement under which:

(1) A makes a gift of property to B, and
(2) B gifts the property to a trust.

It seems at first that there are two settlors, an indirect settlor ("A") and a direct settlor ("B").[7] Both have provided the *same* property. No issue arises if A and B are both non-resident. What is the position if they are both UK resident? There is no clear provision how to apportion the gains between A and B and, since the gains cannot be subject to tax twice, it is considered that there is no tax charge at all. The courts would certainly have taken that view in the past: see *Lord Herbert v IRC* 25 TC 91. The best solution to the problem is to identify a "real" settlor (presumably B) and infer that A is not to be regarded as the settlor.

If A is UK resident and B is not (or *vice versa*) there is no double charge, but the argument just about still runs that A (the UK settlor) cannot be taxed; though in these circumstances the argument is less meritorious and one would not like to rely on it.

This issue usually arises in the context of failed tax planning of the kind discussed at 58.34 (Planning to create settlement with foreign domiciled settlor).

If A is not UK resident and B is UK resident there is no double charge.

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6 The Manual continues with a straightforward example not printed here.
7 See 58.4 (Gift from A to B followed by gift to trust by B).

B might argue that he is not the "real" settlor. In practice this factual situation should not arise.

37.13 Interaction of ss.86 and 87 TCGA

This section considers the interaction of ss.86 and 87 TCGA. For the interaction with s.731, see 19.10 (Interaction of s.731 and s.87 TCGA).

In the absence of relief, a gain accruing to a trust may be attributed to the settlor under s.86(4) and a s.2(2) amount under s.87(2). Section 87(3) TCGA 1992 provides relief for s.87 and so prevents double taxation:

> Where as regards the same settlement and for the same year of assessment—
> (a) chargeable gains, whether of one amount or of 2 or more amounts, are treated as accruing by virtue of section 86(4), and
> (b) an amount falls to be computed under subsection (2) above,
> the amount so computed shall be treated as reduced by the amount (or aggregate of the amounts) mentioned in para (a) above.

I refer to this as "**s.86 current year credit**". That is, s.86 in principle has priority over s.87.

37.14 Role of non-resident trusts from 2008

Non-resident trusts may be useful where:

(1) s.86 TCGA does not apply;
(2) trust holds:
   (a) UK situate property; or
   (b) companies within s.13 TCGA which hold UK situate property.

For if the trust property is held by beneficiaries directly, disposals of the UK situate property are chargeable on an arising basis; if the same property is held on a trust, disposals by the trustees are taxable on a capital payments basis.

37.15 UK resident trust

A UK resident trust is in principle subject to CGT even if the settlor is a foreign domiciliary. This applies even if the assets are not situated in the UK. The remittance basis does not apply as that only applies to "individuals"; trustees are not individuals.

One might avoid this problem for the future by exporting the trust (appointing non-resident trustees) but there may in principle be a migration charge.[8]

One solution may be to transfer assets from the trust to foreign domiciled beneficiaries absolutely. Although this involves a disposal by the trustees, it may be possible to claim CGT hold-over relief. The relief applies on a disposition to a UK resident foreign domiciled beneficiary, even though that beneficiary may later be able to dispose of the asset without a CGT charge.

8 See 6.4 (Exit charge for trusts).

CHAPTER THIRTY EIGHT

GAINS OF NON-RESIDENT TRUSTS: S.87

38.1 The s.87 charge – Introduction

This chapter considers the CGT charge on beneficiaries under s.87 TCGA, which I call the "**s.87 charge**". The charge is supplemented by a further charge in s.89 TCGA but I use the expression "s.87 charge" loosely to refer to both charges.

The FA 2008 has rewritten the s.87 charge. In the following discussion the "**pre-2008 s.87**" means the section as it was before the 2008 amendments. "**HMRC s.87 guidance note**" means the 54 page guidance note published 8 May 2009 and entitled "FA 2008 changes to the CGT charge on beneficiaries of non-resident settlements".

For where the beneficiary is a charity, see Taxation of Charities (Kessler & Brown 7th ed, 2009, Chap. 29 (Payments to charity from non-resident trusts).

For losses, see 40.6 (Disallowance of personal losses against s.87 gains) and 40.5 (Losses of non-resident trustees).

For OIG s.87, see 23.18 (OIG s.87 charge).

38.2 "Settlement"

Section 97(7) TCGA provides:

> In sections 86A to 96 and Schedule 4C and in this section—
> "settlement" has the meaning given by section 620 of ITTOIA 2005, and
> "settled property" and references (however expressed) to property comprised in a settlement shall be construed accordingly.

"Settlement" here means settlement-arrangement, but in practice one is normally concerned with trusts in the classic sense.[9]

38.3 "Trustees"

Section 97(7A) TCGA provides:

> [a] In this section, sections 86A to 96 and Schedule 4C "trustee", in relation to a settlement in relation to which there would be no trustees apart from this subsection, means any person in whom the settled property or its management is for the time being vested
> [b] (and a person who is treated as a trustee of the settlement by virtue of this subsection shall be treated as a trustee of the settlement for the purposes of section 69).

This would apply to an entity which was a settlement-arrangement and (not being a classic settlement) had no trustees in the normal sense of the word.[10] An example is a Liechtenstein stiftung (foundation).

Section 97(7A) was introduced by para 15 Sch 12 FA 2006. Para 15(3) provides:

> This paragraph shall come into force on 6th April 2006 (in relation to settlements whenever created).

This raises the interesting possibility that s.87 did not apply to foundations[11] before 2006/07 as they had no "trustees". But it is suggested that where the word "settlement" is given the wide and artificial meaning of settlement-arrangement, the word "trustee" should be construed widely too. Section 97(7A) is only for the avoidance of doubt and the law previously was the same.

38.4 Non-resident settlement condition

Section 87(1) TCGA sets out the fundamental condition for the application of s.87:

9 See 56.5.1 (Is an estate a "settlement" within s.87 TCGA?).
10 The drafting is derived from s.45 IHTA.
11 Or other settlement-arrangements which were not classic settlements and so had no trustees in the strict sense.

> This section applies to a settlement for a tax year ("the relevant tax year") if the trustees are neither resident nor ordinarily resident in the UK in that year.

Statute often refers to a settlement "to which s.87 applies"; from 1998/99 this is a roundabout way of saying, a non-resident settlement.

Which is the test of trustee residence for the purposes of s.87? In the case of a settlement-arrangement which is not a trust for CGT purposes, such as a foundation, the drafter realised that the standard CGT trust residence definition would not otherwise apply (it applies only to a classic settlement). Section 97(7A)[b] expressly applies the standard CGT definition of residence. In the more usual case of a settlement-arrangement which is also a classic settlement, there is no express provision but the drafter of s.97(7A), I think, assumed that the standard CGT trust residence definition applies. This is not self-evidently correct, but it is probably the better view. In practice the question will not often arise.

38.5 The s.87 charge

Section 87(2) TCGA provides:

> [a] Chargeable gains are treated as accruing in the relevant tax year to a beneficiary of the settlement
> [b] who has received a capital payment from the trustees in the relevant tax year or any earlier tax year
> [c] if all or part of the capital payment is matched (under s.87A as it applies for the relevant tax year) with the s.2(2) amount for the relevant tax year or any earlier tax year.

The key terms here are "capital payment" "s.2(2) amount" and "matching". I refer to gains treated as accruing as "**deemed s.87 gains**".

A deemed s.87 gain accrues in the year that a capital payment is matched with a s.2(2) amount. That may be later than the year that the capital payment is made.

Section 87 is not strictly a charging section, it feeds into s.2 TCGA which imposes the charge. It is nevertheless convenient to use the expression "s.87 charge" as a shorthand.

38.6 Section 2(2) amount

Section 87(4) TCGA provides:

> The s.2(2) amount for a settlement for a tax year for which this section applies to the settlement is—
> (a) the amount upon which the trustees of the settlement would be chargeable to tax under s.2(2) for that year if they were resident and ordinarily resident in the UK in that year, or
> (b) if s.86 applies to the settlement for that year, the amount mentioned in para (a) minus the total amount of chargeable gains treated under that section as accruing in that year.

The term "s.2(2) amount" has more or less the same meaning as the term "trust gains" in the pre-2008 s.87. The old terminology was clearer, and EN FB 2008 itself uses the term "trust gains." However it is better practice to adopt the statutory terminology rather than to use a separate term with the same meaning as the statutory defined term. Some practitioners use the term "stockpiled gains" but I suggest it is best to use the statutory term or to describe the trust as having a pool of s.2(2) amounts.

There is a s.2(2) amount *for a tax year*: ie each s.2(2) amount must be linked to a specific tax year. The expression "s.2(2) amounts" (in the plural) is used to refer to the case where there are s.2(2) amounts for more than one tax year.

Section 87(4)(b) TCGA deals with the interaction of ss.86 and 87. Gains treated as accruing to the settlor under s.86 are deducted from the s.2(2) amount. This avoids double taxation.

Section 87(5) provides:

> The s.2(2) amount for a settlement for a tax year for which this section does not apply to the settlement is nil.

This makes sense, of course, since if s.87 does not apply the trustees must be UK resident and within the scope of CGT.

38.6.1 *Annual exemption*

HMRC say:

> The trustees compute gains as if they were resident in the UK. Any exemptions and reliefs due to resident trustees are included in this computation. But no annual exempt amount is available.[12]

The last sentence is wrong, as s.3 TCGA (extended to trustees by sch 1 TCGA) provides that trustees "shall not be chargeable to CGT" on the exempt amount. So "the amount upon which the trustees would be chargeable to tax under s.2(2) for that year if they were resident and ordinarily resident in the UK in that year" is reduced by the exempt amount. The Courts might disapply the plain words if the result were absurd, but it is not absurd. One could even say it was sensible. Of course, there is not much money at stake here.

38.7 Capital payment

38.7.1 *Definition of capital payment*

"Capital payment" is defined in s.97(1) TCGA:

> In sections 86A to 96 and Schedule 4C and this section "capital payment" ...
> (a) means
>   [i] any payment which is not chargeable to income tax on the recipient
>   [ii] or, in the case of a recipient who is neither resident nor ordinarily resident in the UK, any payment received otherwise than as income,[13] ...

38.7.2 *"Chargeable to income tax"*

What is the position if a remittance basis taxpayer receives income from a non-resident trust which is not remitted? It is considered that the income is "chargeable" to income tax even if no tax is paid because of the

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12 "HMRC Residency: Non-resident trusts" published online at *www.hmrc.gov.uk/cnr/nr_trusts.htm* on 1 April 2008. The document is referring to the pre-2008 legislation (it became out of date 5 days after publication) but the new legislation is the same on this point.

13 As to what is an income/capital receipt from a trust, see 11.18 (Payment from discretionary trust: income or capital?).

remittance basis.[14] Otherwise whenever a trust distributes income to a UK resident foreign domiciliary before 2008/09 it also made a "capital payment" (and reduced s.2(2) amounts); that would be very odd.

See too 19.10 (Is a benefit within s.731 a capital payment?).

38.7.3 *"Payment"*

Section 97(2) TCGA provides:

> In subsection (1) above references to a payment include references to
> [a] the transfer of an asset and
> [b] the conferring of any other benefit, and to
> [c] any occasion on which settled property becomes property to which s.60 applies.

The meaning of "benefit" is discussed at 19.4 (Benefit) because the issues overlap with s.731 ITA.

38.7.4 *Arm's length transaction*

Section 97(1) TCGA provides:

> In sections 86A to 96 and Schedule 4C and this section "capital payment"—

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14 Before 2005 the former s.65 ICTA drew a distinction between a "charge" and a "computation;" unremitted income was described as "chargeable" even though ignored in the computation of the charge. This is still the case: ITTOIA imposes a charge on all RFI and the remittance basis only affects the amount on which the charge is made. See 34.4.4 (Foreign dividend income under the remittance basis: 2005/6 and 2006/7).
It was assumed by the drafter of s.37 TCGA (consideration chargeable to tax on income) that unremitted foreign income is "charged" to income tax. Otherwise there would be a charge to CGT on unremitted income of an asset to which the RFI remittance basis applies but the CGT remittance basis does not apply. That would apply to a UK domiciled and resident but not ordinarily resident individual. Another example would be income accruing to a foreign domiciliary from an asset which was UK situate for CGT purposes, but a foreign income source for income tax purposes.
It is true that the word "chargeable" takes its meaning from the context, and in some contexts unremitted income is not regarded as chargeable to IT. But the context shows that is not the case here.

> (b) does not include a payment under a transaction entered into at arm's length if it is received on or after 19th March 1991.

It is considered that a transaction at arm's length could not be a capital payment at all, and this provision was inserted only for the avoidance of doubt; even if (contrary to my view) it were a capital payment, the amount of the payment would normally be nil. But the issue now will not often arise.

38.7.5 *Termination of settlement*

The termination of a settlement constitutes a capital payment, so any s.2(2) amounts at that time will be attributed to the beneficiaries who become entitled to the trust property: s.97(2)[c] TCGA. This rule should not, in practice, affect well drafted settlements, whose life may extend for a century or more. If action is taken in time it will generally be possible to extend the life of poorly drafted settlements by appropriate exercise of trustees' powers. Trustees should if appropriate diarise the date when the settlement may come to an end so as to take action beforehand.

38.7.6 *Amount of capital payment*

Section 97(4) TCGA provides:

> For the purposes of sections 86A to 96 and Schedule 4C the amount of
> [a] a capital payment made by way of loan, and
> [b] of any other capital payment which is not an outright payment of money,
> shall be taken to be equal to the value of the benefit conferred by it.

That seems self-evident. The valuation of benefits is discussed at 19.4 (Benefit).

38.7.7 *Payment to company*

SP 5/92 para 18 provides:

> In general, transactions between trustees and companies which they, directly or indirectly, wholly own, or between such companies, are … not treated as capital payments within TCGA 1992 s 97.

The paragraph sets out a commonsense definition of "wholly owned" and concludes with a qualification:

> This approach may not, however, be taken where, on the facts of a particular case, it appears that the transaction has been entered into solely or mainly for the purposes of obtaining a UK tax advantage.

Sections 87C and 96 TCGA 1992 (not discussed here) also need consideration.

38.8 Receipt from the trustees

The s.87 charge applies where a beneficiary has received a capital payment from the trustees. There are two requirements here: a *receipt,* and a receipt *from the trustees.*

Section 97(5) TCGA expands on both these concepts:

> For the purposes of sections 86A to 90 and Schedule 4C a capital payment shall be regarded as received by a beneficiary from the trustees of a settlement if—
> (a) he receives it from them directly or indirectly, or
> (b) it is directly or indirectly applied by them in payment of any debt of his or is otherwise paid or applied for his benefit, or
> (c) it is received by a third person at the beneficiary's direction.

On the general meaning of "receipt" see 19.5 (Who is the recipient of a benefit?).

38.8.1 *Indirect receipt from trustees*

In *Herman v HMRC* [2007] STC (SCD) 571 there was an arrangement under which:

(1) Trust 1 transferred funds to trust 2.
(2) Trust 2 transferred the funds to a beneficiary ("B").

The Special Commissioner held that B had received funds directly from trust 2[15] *and* indirectly from trust 1. This is an unsatisfactory decision, because parts of the reasoning are obviously flawed;[16] because of its casual disregard of double taxation; but most of all because no attempt was made to distinguish between cases where a capital payment is or is not received indirectly from trustees, thus leaving taxpayers (and indeed HMRC) none the wiser in other cases:

> 21 The right approach, I think, is to make an enquiry, using whatever signposts appropriate to the circumstances are available, and to determine whether the receipts of [B] can *properly* be linked to the disposition from [trust 1] as their indirect source.

Of course this begs the question of what is meant by the evaluative term *properly.*

> An obvious *signpost* will be the existence of a plan, if there is one. In the present circumstances the appointment by the trustees of [trust 1] was in pursuance of a scheme ...; it will be relevant to the enquiry to determine whether the plan as a whole envisaged that [B] should receive the amounts that they did. If the relevant receipt resulted by accident or on account of circumstances not envisaged by the scheme, then the linkage *may* not be there.

This is too tentative a strict plan of the kind found in *Herman* is not the signpost but the end of the matter; conversely if the receipt resulted by accident (assuming trusts have accidents) then the linkage cannot be there.

> The second signpost is to analyse the trust law and determine whether [trust 2] "served as a vehicle to receive and continue the act of bounty effected by" the trustees[17] of [trust 1] (see the words of Lord Walker in para 41 of *West v Trennery*)....

This is misconceived, for *all* transferee trusts "serve as a vehicle to receive and continue the act of bounty" effected by the settlor of the transferor trust.

The better view is that *Herman* was wrongly decided. If however it is

15 [2007] STC (SCD) 571 at [17].

16 In particular, the reliance on *West v Trennery* at [17].

17 "Trustees" is a slip for settlor, for the trustees do not confer any bounty.

regarded as right (and adopting the jurisprudence of legal realism, the temptation to do down the tax avoidance scheme involved may prove irresistible) there is no point in looking to the decision to find the test of when a payment from trust 2 should also be regarded as an indirect payment from trust 1. The guidance is not there. We are therefore thrown back to first principles. On that basis it is considered that the concept of indirect receipt should be limited to cases where there is a tightly drawn up scheme (as in *Herman*) under which (in the absence of the most unlikely changes of circumstances) payments are inevitably to be made from trust 1 to trust 2, and from trust 2 to the beneficiary. The scheme of s.90 TCGA (and the double taxation consequences from any other view) show that this is the case.

38.9 Matching

38.9.1 *Why does matching matter?*

The matching of capital payments with s.2(2) amounts is important for many reasons:

(1) *Time of charge:* The deemed s.87 gains accrue in the year that a capital payment is matched with a s.2(2) amount.
(2) *Amount of charge:* The amount of the s.87 deemed gain is the amount of the capital payment or the amount matched, if less.
(3) *Which beneficiaries come into charge:* if
  (a) more than one beneficiary receives capital payments, and
  (b) there are not enough s.2(2) amounts to match all the capital payments
  the question which capital payment is matched with a s.2(2) amount makes all the difference as to which beneficiary receives deemed s.87 gains.
(4) *Which capital payments come into charge:* if
  (a) one beneficiary receives more than one capital payment, some in and some outside the UK; and
  (b) there are not enough s.2(2) amounts to match all the capital payments
  the question which capital payment is matched with a s.2(2) amount matters for the remittance basis. If a UK benefit is matched, there is a charge; if a non-UK benefit is matched, the s.87 remittance basis

offers a defence to the charge.

(5) *The interest surcharge,* which depends on the time gap between a capital payment and the s.2(2) amount with which it is matched.

(6) *2008 transitional relief*, which applies where post-2008 capital payments are matched to pre-2008 s.2(2) amounts.

Matching is carried out on a LIFO (last in first out) basis. EN FB 2008 provides a summary:

> 452. Where the s.2(2) amount is equal to or greater than the capital payments then all the capital payments are matched:
> [1] any surplus s.2(2) amount is carried back to the year preceding the current tax year and any unmatched capital payments of that earlier year are matched to the surplus s.2(2) amount;
> [2] any surplus s.2(2) amount is carried back to the preceding year and matched with unmatched capital payments of that year, and so on, until the s.2(2) amount has been reduced to nil or there are no unmatched capital payments left in any earlier year; and
> [3] any surplus s.2(2) amount left after matching to previous years is available to match against future capital payments.
> 453. Where the amount of capital payments for the latest relevant tax year is greater than the s.2(2) amount for that year, then the surplus capital payments are carried back in the same way as surplus s.2(2) amounts, matching the surplus capital payments against the unmatched trust gains of each earlier year, starting with the latest year first and only moving back to an earlier year where there are no unmatched trust gains left in the later year. Any capital payments that remain unmatched are carried forward from the current tax year to be matched against the s.2(2) amounts of future years. ...
> 455. Note that:
> [1] the matching rules are modified by new subs.(4) of s.762 ICTA in relation to offshore income gains; and
> [2] capital payments are matched to trust gains within a given tax year on a pro rata basis, not on a daily basis.

The rules changed from a FIFO to a LIFO basis in 2008. HMRC did not state why they made this change. I surmise that it was done to minimise the benefit of 2008 transitional relief, which applies if post-2008 capital payments are matched with pre-2008 s.2(2) amounts. The old rule would have maximised the benefit of the relief, so that very large trusts with substantial s.2(2) amounts may have been free of CGT for a substantial period of time. Had the reason been given, there might have been some debate about whether the benefit justified the change, but as it was, there was none. But there it is.

38.9.2 *The statute*

Section 87A TCGA provides:

> **87A Section 87: matching**
> (1) This section supplements s.87.
> (2) The following steps are to be taken for the purposes of matching capital payments with s.2(2) amounts.
> *Step 1*
> Find the s.2(2) amount for the relevant tax year.
> *Step 2*
> Find the total amount of capital payments received by the beneficiaries from the trustees in the relevant tax year.

Armed with these figures we proceed to the matching rule:

> *Step 3*
> The s.2(2) amount for the relevant tax year is matched with—
> (a) if the total amount of capital payments received in the relevant tax year does not exceed the s.2(2) amount for the relevant tax year, each capital payment so received, and
> (b) otherwise, the relevant proportion of each of those capital payments.
> "The relevant proportion" is the s.2(2) amount for the relevant tax year divided by the total amount of capital payments received in the relevant tax year.

I refer to a case within (a) as a "**surplus s.2(2) amount**" and a case within (b) as a "**surplus capital payment".**

The next step is a recomputation of the s.2(2) amount and of the amount of capital payments

> *Step 4*
> [1] If para (a) of Step 3 applies—

That is, if there is a surplus s.2(2) amount—

(a) reduce the s.2(2) amount for the relevant tax year by the total amount of capital payments referred to there, and
(b) reduce the amount of those capital payments to nil.

I refer to the s.2(2) amount after this reduction as "**the unmatched s.2(2) amount**".

[2] If para (b) of that Step applies—

That is the case of a surplus capital payment—

(a) reduce the s.2(2) amount for the relevant tax year to nil, and
(b) reduce the amount of each of the capital payments referred to there by the relevant proportion of that capital payment.

I refer to the amount of the capital payments after this deduction as "**the unmatched capital payments**".

Then one starts again at the beginning, but with modifications:

Step 5
[1] Start again at Step 1 (unless subs.(3) applies).
[2] If the s.2(2) amount for the relevant tax year (as reduced under Step 4) is not nil, read references to capital payments received in the relevant tax year as references to capital payments received in the latest tax year which—
(a) is before the last tax year for which Steps 1 to 4 have been undertaken, and
(b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries.

I again refer to a case within step 5[2] (where there is an unmatched s.2(2) amount) as a "**surplus s.2(2) amount".**

Amended as step 5[2] directs, Steps 1-4 become:

Step 1
Find the s.2(2) amount for the relevant tax year [i.e. the unmatched s.2(2) amount].
Step 2
Find the total amount of capital payments received by the beneficiaries from the trustees ~~in the relevant tax year~~ *in the latest tax year which—*

(a) is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries.

Step 3

The s.2(2) amount for the relevant tax year is matched with—

(a) if the total amount of capital payments received ~~in the relevant tax year~~ *in the latest tax year which—*

(a) is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries.

does not exceed the [unmatched] s.2(2) amount for the relevant tax year, each capital payment so received, and

(b) otherwise, the relevant proportion of each of those capital payments.

"The relevant proportion" is the [remaining] s.2(2) amount for the relevant tax year divided by the total amount of capital payments received ~~in the relevant tax year~~ *in the latest tax year which—*

(a) is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries.

Step 4

If para (a) of Step 3 applies—

(a) reduce the [unmatched] s.2(2) amount for the relevant tax year by the total amount of capital payments referred to there, and

(b) reduce the amount of those capital payments to nil.

If para (b) of that Step applies—

(a) reduce the [unmatched] s.2(2) amount for the relevant tax year to nil, and

(b) reduce the [unmatched] amount of each of the capital payments referred to there by the relevant proportion of that capital payment.

Eventually the unmatched s.2(2) amount is reduced to nil (ie all the s.2(2) amount is matched). Then step 5[2] ceases to apply. The journey then takes us to step 5[3]:

Step 5

[3] If the s.2(2) amount for the relevant tax year (as so reduced) is nil, read references to the s.2(2) amount for the relevant tax year as the s.2(2) amount for the latest tax year—

(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) for which the s.2(2) amount is not nil.

I refer to a case within step 5[3] as a "**surplus capital payment".** This is a case where:

(1) there is no unmatched s.2(2) amount for the relevant year;
(2) there is a s.2(2) amount for an earlier year.

Amended as step 5[3] directs, steps 1-4 become:

> *Step 1*
> Find the s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year —*
> *(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and*
> *(b) for which the s.2(2) amount is not nil.*
> *Step 2*
> Find the total amount of capital payments received by the beneficiaries from the trustees in the relevant tax year.
> *Step 3*
> The s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year—*
> *(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and*
> *(b) for which the s.2(2) amount is not nil*
> is matched with—
> (a) if the total amount of capital payments received in the relevant tax year does not exceed the s.2(2) amount ~~for the relevant tax year~~, *for the latest tax year—*
> *(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and*
> *(b) for which the s.2(2) amount is not nil.*
> each capital payment so received, and
> (b) otherwise, the relevant proportion of each of those capital payments.
> "The relevant proportion" is the s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year—*
> *(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and*
> *(b) for which the s.2(2) amount is not nil.*
> divided by the total amount of capital payments received in the relevant tax year.
> *Step 4*
> If para (a) of Step 3 applies—
> (a) reduce the s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year—*
> *(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and*
> *(b) for which the s.2(2) amount is not nil.*
> by the total amount of capital payments referred to there, and
> (b) reduce the amount of those capital payments to nil.
> If para (b) of that Step applies—

(a) reduce the s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year—*

(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) for which the s.2(2) amount is not nil.

to nil, and

(b) reduce the amount of each of the capital payments referred to there by the relevant proportion of that capital payment.

38.9.3 *When to stop*

Section 87A(3) TCGA (incorporated at step 5[1]) states when one can stop repeating these steps:

> This subsection applies if—
> (a) all of the capital payments received by beneficiaries from the trustees in the relevant tax year or any earlier tax year have been reduced to nil, or
> (b) the s.2(2) amounts for the relevant tax year and all earlier tax years have been reduced to nil.

That is, one stops when there are no unmatched capital payments or s.2(2) amounts.

Section 87A(4) TCGA provides:

> The effect of any reduction under Step 4 of subsection (2) is to be taken into account in any subsequent application of this section.

That seems self-evident.

38.9.4 *HMRC example: surplus s.2(2) amount*

EN FB 2008 provide two examples. *Text in italics represents HMRC comments:*

> ***56. Section 87A: Example 1: section 2(2) amount is greater than the total amount of capital payments for latest tax year:***
> The facts assumed in the example are as follows:
> *2008-09: no surplus trust gains or surplus capital payments*

Year	*Capital payment*	*s.2(2) amount*
2009-10:	*£100k*	*nil*
2010-11:	*£200k*	*nil*
2011-12:	*£500k*	*nil*
2012-13:	*£500k*	*£2m*

I set out the text of the relevant steps in the analysis.

> *Step 1*
> Find the s.2(2) amount for the relevant tax year.
> *Step 2*
> Find the total amount of capital payments received by the beneficiaries from the trustees in the relevant tax year.

The relevant tax year is 2012/13 and we can take the figures from the table.

We move on to step 3. There is (in my terminology) a surplus s.2(2) amount, because "the total amount of capital payments received in the relevant tax year" (£500k) does not exceed "the s.2(2) amount for the relevant year" (£2m). Accordingly:

> *Step 3*
> The s.2(2) amount for the relevant tax year is matched with—
> (a) ... each capital payment so received,

Thus step 3 states that £2m (the s.2(2) amount for 2012/13) is matched with the £500k capital payment. There are two difficulties with this. First, the charge in s.87(2) requires us to ask whether the *capital payment* is matched with the s.2(2) amount, and step 3 tells us that the *s.2(2) amount* is matched with the capital payment. The answer is that matching is by implication a reflexive operation, i.e. if A is matched with B, then B is matched with A.

Secondly, applying step 3 literally, the capital payment (£500k) is matched with the *entire* s.2(2) amount (£2m). This does not matter because s.87(3) TCGA restricts the charge to the amount of the capital payment. In order to follow s.87(3) one needs to read it together with s.87(2):

> (2) Chargeable gains are treated as accruing in the relevant tax year to a beneficiary of the settlement who has received a capital payment from the trustees in the relevant tax year or any earlier tax year if all or part of the capital payment is matched (under s.87A as it applies for the relevant tax year) with the s.2(2) amount for the relevant tax year or any earlier tax year.
> (3) The amount of chargeable gains treated as accruing is equal to—
> (a) the amount of the capital payment, or
> (b) if only part of the capital payment is matched, the amount of that part.

But the HMRC analysis is as follows:

> *Match as follows:*
> *a. 2012-13 capital payments £500,000 match to £500,000 gains.*

The HMRC analysis (wisely) does not try to refer to the statutory steps which authorise this conclusion. (Indeed, there is no reason to think that the author of the HMRC example read the legislation.) But the end result is the same.

We move on to step 4. Ours is a surplus capital payment case, so step 4 provides:

> *Step 4*
> If para (a) of Step 3 applies—
> (a) reduce the s.2(2) amount for the relevant tax year by the total amount of capital payments referred to there, and
> (b) reduce the amount of those capital payments to nil.

So our revised table becomes:

Year	*Capital payment*	*s.2(2) amount*
2009-10:	*£100k*	*nil*
2010-11:	*£200k*	*nil*
2011-12:	*£500k*	*nil*
2012-13:	*£0 ~~£500k~~*	*£1.5m ~~£2m~~*

The HMRC analysis is as follows:

> *[1] 2012-13 capital payments reduced to nil.*
> *[2] Unmatched 2012-13 trust gains reduced to £1.5 million.*
> *[3] Refer unmatched trust gains to preceding year.*

Point [1] is correct. Points [2] and [3] are a fair paraphrase.

Our journey takes us to step 5:

> *Step 5*
> [1] Start again at Step 1 (unless subsection (3) applies).
> [2] If the s.2(2) amount for the relevant tax year (as reduced under Step 4) is not nil, read references to capital payments received in the relevant tax year as references to capital payments received in the latest tax year which—
> (a) is before the last tax year for which Steps 1 to 4 have been undertaken, and
> (b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries.

There is still a surplus s.2(2) amount (the s.2(2) amount for the relevant tax year is not nil, it is now £1.5m).

We revert to step 2 which now reads:

> *Step 2*
> Find the total amount of capital payments received by the beneficiaries from the trustees ~~in the relevant tax year~~ *in the latest tax year which—*
> *(a) is before the last tax year for which Steps 1 to 4 have been undertaken, and*
> *(b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries*

The "latest tax year" is now 2011-12 and we can take the figures from the revised table.

We move on to step 3. This is a surplus s.2(2) amount case, because "the total amount of capital payments received in the latest tax year" (£500k) does not exceed "the s.2(2) amount for the relevant year" (£1.5m)". Accordingly:

> *Step 3*
> The s.2(2) amount for the relevant tax year is matched with—

(a) ... each capital payment so received,

Thus step 3 states that £1.5m (the unmatched s.2(2) amount) is matched with the £500k capital payment. But the HMRC analysis is as follows:

b. 2011-12 unmatched capital payments £500,000 match to £500,000 gains.

As noted, this is a loose paraphrase of step 3, but it does not matter. We move on to step 4. Ours is a step 3(a) case, so step 4 provides:

Step 4
If para (a) of Step 3 applies—
(a) reduce the s.2(2) amount for the relevant tax year by the total amount of capital payments referred to there, and
(b) reduce the amount of those capital payments to nil.

So:

(a): reduce the s.2(2) amount for the relevant year thus: £1.5m-£500k = £1m.
(b): reduce the capital payment for the latest year [2011-12] to nil.

The HMRC analysis is as follows:

2011-12 capital payments reduced to nil.
Unmatched 2012-13 trust gains reduced to £1 million.
Refer unmatched trust gains to preceding year.

The process repeats once again, but "the latest tax year" now becomes 2009-10. It is not necessary to set out the steps. The reader will already have the idea. The HMRC analysis (or paraphrase) is as follows:

2010-11 unmatched capital payments £200,000 match to £200,000 gains.
2010-11 capital payments reduced to nil.
Unmatched 2012-13 trust gains reduced to £800,000.
Refer unmatched trust gains to preceding year.

The process repeats once again, but "the latest tax year" now becomes 2009-10. It is not necessary to set out the steps. The HMRC analysis (or paraphrase) is as follows:

> *d. 2009-10 unmatched capital payments £100,000 match to £100,000 gains.*
> *2010-11 capital payments reduced to nil.*
> *Unmatched 2012-13 trust gains reduced to £700,000.*
> *Refer unmatched trust gains to preceding year.*

At this point s.87A(3) TCGA applies because "all of the capital payments received by beneficiaries from the trustees in the relevant tax year or any earlier tax year have been reduced to nil". Accordingly the steps come to an end. The HMRC analysis is:

> *e. No unmatched capital payments in 2008-09 or earlier years.*

Lastly, the HMRC analysis provides:

> *Carry forward unmatched trust gains of 2012-13 of £700,000 to be matched against capital payments of 2013-14 and subsequent years.*

This is a reference to step 1 as amended by step 5[3] but the point does not actually arise under the facts of the HMRC example.

It is noteworthy that in order to deal with the facts of the HMRC example (which is a simplication of the facts of a typical case in real life because there is only one s.2(2) amount) one has to carry out 15 steps.

38.9.5 *HMRC example: surplus capital payment*

HMRC's second example is as follows

> ***57. Section 87A: Example 2: capital payments are greater than section 2(2) amount for latest tax year: The facts assumed in the example are as follows:***
>
> *2008-09: no surplus trust gains or surplus capital payments*

Year	*Capital payment*	*s.2(2) amount*
2009-10:	*nil*	*£100k*
2010-11:	*nil*	*£200k*
2011-12:	*nil*	*£500k*
2012-13:	*£2m*	*£500k*

I set out the text of the relevant steps in the analysis.

> *Step 1*
> Find the s.2(2) amount for the relevant tax year.
> *Step 2*
> Find the total amount of capital payments received by the beneficiaries from the trustees in the relevant tax year.

The relevant tax year is 2012/13 and we can take the figures from the table.

We move on to step 3. There is (in my terminology) a surplus capital payment because "the total amount of capital payments received in the relevant tax year" (£2m) does exceed "the s.2(2) amount for the relevant year" (£500k). Accordingly:

> *Step 3*
> The s.2(2) amount for the relevant tax year is matched with—
> (b) ... the relevant proportion of each of those capital payments.

"The relevant proportion" is the s.2(2) amount for the relevant tax year (£500k) divided by the total amount of capital payments received in the relevant tax year (£2m) = 0.25.

Thus step 3 states that £500k (the s.2(2) amount) is matched with one quarter of the capital payment = £500k. As noted, the charge in s.87(2) requires us to ask whether the *capital payment* is matched with the s.2(2) amount, and step 3 tells us that the *s.2(2) amount* is matched with the capital payment. The solution is that matching is a reflexive operation, ie if A is matched with B, then B is matched with A.

The HMRC analysis is as follows:

Match as follows:
a. 2012-13 capital payments £500,000 match to £500,000 gains.

We move on to step 4. Ours is a surplus capital payment case, so step 4 provides:

Step 4
[2] If para (b) of that Step [step 3] applies—
(a) reduce the s.2(2) amount for the relevant tax year to nil, and
(b) reduce the amount of each of the capital payments referred to there by the relevant proportion of that capital payment.

So our revised table becomes:

Year	Capital payment	s.2(2) amount
2009-10:	nil	£100k
2010-11:	nil	£200k
2011-12:	nil	£500k
2012-13:	£1.5m ~~£2m~~	£0 ~~£500k~~

The HMRC analysis is as follows:

Unmatched 2012-13 capital payments reduced to £1.5 million.
Refer unmatched capital payments to preceding year.

Our journey takes us to step 5.

Step 5
[1] Start again at Step 1 (unless subs.(3) applies)....
[3] If the s.2(2) amount for the relevant tax year (as so reduced) is nil, read references to the s.2(2) amount for the relevant tax year as the s.2(2) amount for the latest tax year—
(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and
(b) for which the s.2(2) amount is not nil.

This is a surplus capital payment case, (the s.2(2) amount for 2012–13 is now nil).

We revert to step 3 which now reads:

> *Step 3*
> The s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year—*
> *(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and*
> *(b) for which the s.2(2) amount is not nil*
> is matched with—
> (a) if the total amount of capital payments received in the relevant tax year does not exceed the s.2(2) amount ~~for the relevant tax year~~, *for the latest tax year—*
> *(a) which is before the last tax year for which Steps 1 to 4 have been undertaken,*
> *(b) for which the s.2(2) amount is not nil.*
> each capital payment so received, and
> (b) otherwise, the relevant proportion of each of those capital payments.
> "The relevant proportion" is the s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year*
> *(a) which is before the last tax year for which Steps 1 to 4 have been undertaken,*
> *(b) for which the s.2(2) amount is not nil*
> divided by the total amount of capital payments received in the relevant tax year.

The "latest tax year" is now 2011-12. This is a surplus capital payment case because "the total amount of capital payments received in the relevant tax year" (now £1.5m) does exceed "the s.2(2) amount for the latest year" (£500k). Accordingly:

> *Step 3*
> The s.2(2) amount for the latest tax year is matched with—
> (b) ... the relevant proportion of each of those capital payments.

The relevant proportion is one third.

The process repeats again and again. It is not necessary to set out the steps. The reader will already have the idea. The HMRC analysis (or paraphrase) is as follows:

> *2012-13 trust gains reduced to nil.*
> *b. 2011-12: match 2012-13 capital payments £1.5 million to £500,000 gains.*
> *2011-12 trust gains reduced to nil.*
> *Unmatched 2012-13 capital payments reduced to £1 million.*
> *Refer unmatched capital payments to preceding year.*
> *c. 2010-11: match 2012-13 capital payments £200,000 to £200,000*

gains.
2010-11 trust gains reduced to nil.
Unmatched 2012-13 capital payments reduced to £800,000.
Refer unmatched capital payments to preceding year.
d. 2009-10: match 2012-13 capital payments £100,000 to £100,000 gains. 2010-11 trust gains reduced to nil.
Unmatched 2012-13 capital payments reduced to £700.000.
Refer unmatched capital payments to preceding year.
e. No unmatched trust gains in 2008-09 or earlier years.
Carry forward unmatched capital payments of 2012- 13 of £700,000 to be matched against trust gains of 2013-14 and subsequent years.

It is noteworthy that in order to deal with the facts of the HMRC example (which is a simplication of the facts of a typical case in real life for there is only one capital payment in five years) one has to carry out 15 steps.

38.9.6 *Year of death of beneficiary*

If a beneficiary dies in a year then all gains of that tax year are s.2(2) amounts which can be attributed to the beneficiary, even post-death gains. But gains of a subsequent year cannot be attributed. Section 87 does not say so expressly, but (1) it is difficult even for Parliament to deem gains to accrue to someone who (being dead) does not exist and (2) the context shows no such attribution is intended.

Contrast the rule for s.86 which does not apply to any trust gains accruing in the year that the settlor dies, even pre-death gains. Perhaps the reason for the s.87 rule is that it works (slightly) more fairly when two beneficiaries receive capital payments in a year and one of them dies in that year.

38.9.7 *Comment on the drafting*

The pre-2008 s.87 provided:

> *(4) Subject to the following provisions of this section, the trust gains for a year of assessment shall be treated as chargeable gains accruing in that year to beneficiaries of the settlement who receive capital payments from the trustees in that year or have received such payments in any earlier year.*
> *(5) The attribution of chargeable gains to beneficiaries under*

> *subsection (4) above shall be made in proportion to, but shall not exceed, the amounts of the capital payments received by them.*
> *(6) A capital payment shall be left out of account for the purposes of subsections (4) and (5) above to the extent that chargeable gains have by reason of the payment been treated as accruing to the recipient in an earlier year.*

Few if any readers who will labouriously work endless through the iterative steps of s.87A will consider the new style of wording is an improvement on the old. I have wondered whether the legislation was drafted by someone who trained to write computer programs rather than legislation. The explanation may be that the use of "steps" was an innovation of the tax law rewrite project in the search for new and clearer methods of drafting. If so, however, it must be judged a failure. But the fundamental problem is not the drafting, but the need to match capital payments with trust gains for a year.

38.10 Planning by matching

Matching is a rough and ready rule and trustees need to plan carefully to avoid unfairness.

38.10.1 *Planning to obtain remittance basis*

Suppose:

(1) Years 1–10: A beneficiary ("B") occupies a UK house held by a trust. This is a capital payment.
(2) Year 11: The house is sold for £1m gain and a s.2(2) amount arises.

In principle the s.2(2) amount in year 11 is matched with the capital payments in years 1–10. The deemed s.87 gain is taxed on an arising basis of the benefit received in the UK. If B is UK resident in year 11, this is an expensive matter. Suppose:

(3) Year 11: The trustees make a capital payment of £1m to B outside the UK.

The s.2(2) amount is matched with the £1m capital payment and the deemed s.87 gain is taxed on the remittance basis.

38.10.2 *Planning to avoid interest surcharge*

Since the surcharge matches on a LIFO basis, the charge can be avoided by realising gains in the year that any capital payment is made, so as to frank any capital payment with current year gains. If gains are not actually realised, the rules in schedule 4B TCGA make it fairly easy to realise deemed gains which will do just as well.

38.11 Capital payment received by non-beneficiary

Chargeable gains are treated as accruing in the relevant tax year to *a beneficiary of the settlement* who has received a capital payment from the trustees.

One might think that the charge only applies to beneficiaries so if a capital payment is made to a non-beneficiary there is no charge. However, s.97(8) TCGA provides:

> In a case where—
>
> (a) at any time on or after 19th March 1991 a capital payment is received from the trustees of a settlement or is treated as so received by virtue of section 96(1),
>
> (b) it is received by a person, or treated as received by a person by virtue of section 96(2) to (5),
>
> (c) at the time it is received or treated as received, the person is not (apart from this subsection) a beneficiary of the settlement, and
>
> (d) subsection (9) or (10) below does not prevent this subsection applying,
>
> for the purposes of sections [86A]2 to 90 [and Schedule 4C]3 the person shall be treated as a beneficiary of the settlement as regards events occurring at or after that time.

The drafting is clumsy: the charge applies to a beneficiary but every person is treated as a beneficiary: it would have been easier just to say that the charge applies to a person! One can identify four permutations:

Case No	Time of capital payment	Time deemed gain accrues
1	B	B
2	NB	B
3	B	NB
4	NB	NB

Key: B: Beneficiary
NB: Non-beneficiary

Case 1 (beneficiary status at all times) is caught by s.87(2) directly.

Cases 2 and 4 (not a beneficiary at time of capital payment) are caught by s.87(8). This leaves case 3: the individual is a beneficiary at the time of the capital payment but not when the s.87 deemed gain accrues. Section 97(8) does not apply because the condition in s.97(8)(a) does not apply,. It is considered that s.87(2) should be construed widely so as to catch this case, otherwise there would be a strange anomaly in the legislation.

38.11.1 *Exceptions*

There are two exceptions to the rule in s.97(8). Section 97(9) TCGA provides:

> Subsection (8) above shall not apply where a payment mentioned in para (a) is made in circumstances where it is treated (otherwise than by subsection (8) above) as received by a beneficiary.

I cannot understand this.

Section 97(10) provides:

> Subsection (8) above shall not apply so as to treat—
> (a) the trustees of the settlement referred to in that subsection, or
> (b) the trustees of any other settlement,
> as beneficiaries of the settlement referred to in that subsection.

38.12 Interest surcharge

Section 91(1) TCGA provides:

> This section applies if—
>
> (a) chargeable gains are treated under s.87 or 89(2) as accruing to a beneficiary by virtue of the matching (under s.87A) of all or part of a capital payment with the s.2(2) amount for a tax year ("the relevant tax year"),
>
> (b) the beneficiary is charged to tax by virtue of that matching, and
>
> (c) the capital payment was made more than one year after the end of the relevant tax year.

It is not enough that chargeable gains to accrue to a beneficiary, and that the beneficiary is charged to tax; this must be "by virtue of the matching". But since gains never accrue unless there is matching, and the beneficiary is never charged unless there is matching, the words appear to be otiose. Section 91 continues to deal with part matching:

> (1A) Where part of a capital payment is matched, references in subsections (2) and (3) to the capital payment are to the part matched.

We then turn to the tax increase:

> (2) [a] The tax payable by the beneficiary in respect of the payment shall be increased by the amount found under subsection (3) below,
>
> [b] except that it shall not be increased beyond the amount of the payment;
>
> [c] and an assessment may charge tax accordingly.

Para 2[b] stops the Treasury increasing the rate of tax beyond 100%. One would hope it is not necessary.

Para 2[c] is otiose. Section 91 continues to set out the amount of the increase:

> (3) The amount is one equal to the interest that would be yielded if an amount equal to the tax which would be payable by the beneficiary in respect of the payment (apart from this section) carried interest for the chargeable period at the rate of 10 per cent per annum.

Thus we have a notional 10% interest – the rate bears no relation to actual interest rates – for a period called a chargeable period.

> (4) The chargeable period is the period which—
> (a) begins with the later of the 2 days specified in subsection (5) below, and
> (b) ends with 30th November in the year of assessment following that in which the capital payment is made.
> (5) The 2 days are—
> (a) 1st December in the tax year immediately after the relevant tax year, and
> (b) 1st December falling 6 years before 1st December in the year of assessment following that in which the capital payment is made.

Thus the chargeable period cannot exceed 6 years and the maximum surcharge is 60%.

I call this the "**interest surcharge.**" It is not in fact interest but the wording is designed to give it the some of the appearance of interest.

For completeness, the Treasury may alter the rules;[18] but they have never done so.

What is the position if the s.87 remittance basis applies? Section 12(2) TCGA (applied by s.87B TCGA, discussed below) provides:

> Chargeable gains are treated as accruing to the individual in any tax year in which any of the foreign [deemed, s.87] chargeable gains are remitted to the UK.

One might argue that there is no interest surcharge, because the gains are not charged to tax by virtue of matching; they are charged by virtue of the remittance. But the better view is the charge applies (by reference to the

---

18 Section 91 TCGA continues:

"(6) The Treasury may by order substitute for the percentage specified in subsection (3) above (whether as originally enacted or as amended at any time under this subsection) such other percentage as they think fit.

(7) An order under subsection (6) above may provide that an alteration of the percentage is to have effect for periods beginning on or after a day specified in the order in relation to interest running for chargeable periods beginning before that day (as well as interest running for chargeable periods beginning on or after that day)."

year of capital payment, not by reference to the year of remittance), and this is the HMRC view: see 37.14.10 (HMRC example).

38.12.1 *Commentary*

What is the reason for the interest surcharge? It is to counter the perceived advantage that UK trusts pay CGT on an arising basis, but non resident trusts (outside s.86) pay CGT on a capital payments basis, which is more favourable. But it works very oddly and unfairly, particularly after the extension of s.87 to foreign domiciled settlors and beneficiaries in 2008. For instance, consider a trust set up some years ago by an Australian for Australian beneficiaries; one beneficiary comes to the UK and receives a capital payment here. Why should there be a surcharge?

Following the 2008 reforms the surcharge is not likely to bring in sufficient tax to justify the complications that it causes. The case for repeal of the rule is very strong.

38.13 Non-resident beneficiary

It does not matter that s. 87 deemed gains accrue to a beneficiary who is non-resident (unless the temporary non-residence rules apply) since the gains are not subject to CGT. But the time which matters is when the gains accrue, so the matching rules need to be considered and pose something of a trap.

Suppose:

(1) Year 1: A capital payment is made to a beneficiary ("B") when he is non-resident. There are no s.2(2) amounts so that the capital payment is not matched.

(2) Year 2: A s.2(2) amount accrues when B is UK resident.

The capital payment is matched in year 2, so the s.87 deemed gain it is chargeable (subject to the s.87 remittance basis).

38.13.1 *Planning for beneficiary coming to UK*

This problem arises if a beneficiary has an unmatched capital payment before coming to the UK. In this situation the trustees should trigger gains in year 1. The capital payment will then be matched in year 1, and will not come into charge in year 2.

38.13.2 *Commentary*

It is suggested that (subject to the temporary non-residence rules) a gain accruing to a non-resident should not come into charge. The charge only affects those who fail to take the necessary planning, and in many of those cases it is likely that it will be overlooked or tacitly ignored by non-compliant taxpayers.

38.14 Section 87 remittance basis

Before 2008/9 a beneficiary who is not domiciled in the UK was altogether exempt from the s.87 charge regardless of his residence and regardless of the domicile of the settlor. This rule is abolished from 2008/9. Section 87B TCGA provides a relief which I call the "**s.87 remittance basis**". Section 87B(1) provides:

> This section applies if—
> (a) chargeable gains are treated under s.87 as accruing to an individual in a tax year,
> (b) s.809B, 809D or 809E (remittance basis) applies to the individual for that year, and
> (c) the individual is not domiciled in the UK in that year.

In short, the relief applies to remittance basis taxpayers. Section 87B(2) provides the relief:

> The chargeable gains are foreign chargeable gains within the meaning of s.12 (non-UK domiciled beneficiaries to whom remittance basis applies).

The effect of s.87B(2) is to incorporate the ITA remittance basis. Section 87B continues:

> (3) For the purposes of Chapter A1 of part 14 of ITA 2007 (remittance basis) treat relevant property or benefits as deriving from the chargeable gains.
> (4) For the purposes of subsection (3) property or a benefit is "relevant" if the capital payment by reason of which the chargeable gains are treated as accruing consists of—
> (a) the payment or transfer of the property or its becoming

property to which s.60 applies, or
(b) the conferring of the benefit.

A rule of this kind is needed because deemed s.87 gains (being fictional) could not be remitted. The drafting of s.87B(4) is odd because a capital payment will always fall within (a) or (b) so every capital payment is a relevant payment. But it does not matter.

A capital payment still reduces the s.2(2) amount even though the payment is (un)taxed under the s.87 remittance basis. This is sensible because other beneficiaries (and the trustees) could not know what the position was.

It does not matter whether the s.2(2) amounts arise on disposals of UK or foreign assets. All that matters is whether the capital payment is remitted to the UK. HMRC agree. FAQ Residence & Domicile – NR trusts provides:

> **Does it make any difference if the assets in the non-resident trust or underlying non-resident company owned by the trust are UK situated?**
> There is no different in the Capital Gains Tax treatment of UK situated vs foreign situated assets when these are owned by a non-resident trust or underlying non-resident company. However, as under current law, any UK source income produced by the trust or company will be taxed on the UK resident settlor or transferor on an arising basis irrespective of whether he has received any benefit if he has power to enjoy such income at the date it arises.

HMRC s.87 guidance provides:

> 43. The remittance basis applies to the section 87 gain not the gain that created the section 2(2) amount. For example, trustees dispose of an asset held outside the UK creating a section 2(2) amount. In the same year they make a capital payment outside the UK to a non-domiciled beneficiary. The capital payment is matched against the section 2(2) amount. A section 87 gain accrues to the beneficiary who has claimed the remittance basis for that year. The trustees apply the proceeds of the disposal in buying investments in the UK. This remittance of the gain which created the section 2(2) amount is not treated as a remittance of the section 87 gain by the beneficiary.

A capital payment may be remitted to the UK in a year before the s.87 deemed gains accrue, due to the quirky matching rules. Suppose:

(1) Year 1: a beneficiary receives a benefit; there are no s.2(2) amounts so the benefit is not matched and no s. 87 deemed gains accrue.
(2) Year 2: the beneficiary remits the benefit to the UK. There is still not tax charge.
(3) Year 3: s.2(2) amounts accrue to the trustees and a deemed s.87 gain accrues to the beneficiary.

This gain is deemed to be remitted in the year it arises (year 3) and not before.[19]

38.14.1 *HMRC example*

HMRC s.87 guidance provides:

> **Example 8 – New section 87B - remittance of capital payment: payment**
> A is a UK resident and domiciled beneficiary of a non-UK resident settlement. B is a UK resident but non-UK domiciled beneficiary of the same settlement. The settlement owns shares in X Inc. X Inc is an American company registered on the New York Stock Exchange.[20]
> In 2008-09 the trustees sell shares in X Inc for \$120,000 when the spot rate is £1 = \$1.50. The acquisition cost of the shares was \$20,000 when spot was also £1 = \$1.50. This creates a section 2(2) amount of £66,666 for 2008-09, ie \$100,000 @ 1.50.
> In 2010-11 the trustees make capital payments of \$40,000 into the US bank accounts of each beneficiary. The spot rate of the US dollar at the date of the payment is £1 = \$1.75. Chargeable gains of £22,857 accrue to each beneficiary under section 87 in 2010-11 in respect of these capital payments. \$40,000 @ \$1.75 = £22,857.
> At the time of writing the annual exempt amount and rate of Capital Gains Tax are not known for 2010-11 and 2012-13. This example assumes the rate of Capital Gains Tax is 18% for both years and the annual exempt amount was £10,000 in 2010-11 and £11,000 in 2012-13.
> Beneficiary A has other gains in 2010-11. The overall position is as follows.
> - Section 87 gains £22,857
> - Other personal gains £40,000
> - Other personal losses £20,000
> - Annual exempt amount £10,000
>
> The amount on which Capital Gains Tax is chargeable is £32,857. The personal

19 See 10.41 (remittance before income or gains arise).

20 This sentence is irrelevant, as the situs of the asset does not matter for s.87 purposes.

losses can be set only against the other personal gains but the annual exempt amount is allocated first to the section 87 gain leaving £12,857 of that part of the gain chargeable at 18%. The tax due on £12,857 is £2,314 (£12,857 @ 18%). This is increased by £462 (£2,314 @ 20%) because there is a delay of over one year in making the capital payment.

Beneficiary B claims the remittance basis for 2010-11 and leaves the $40,000 in the US bank account. B also has other gains in 2010-11. These gains and losses arise on the disposal of assets situated in the UK. The overall position is as follows.

- Section 87 gains £22,857
- Other personal gains on UK assets £40,000
- Other personal losses on UK assets £20,000

B does not have an annual exempt amount in 2010-11 because they have claimed the remittance basis. B is not liable to Capital Gains Tax on the section 87 gain of £22,857 because of section 87B. B is liable to CGT at 18% on the full amount of the other net personal gains £20,000.

Because B has claimed the remittance basis they also have to decide whether or not to make an election under section 16ZA TCGA. The effect of that election is allow losses on the disposal of assets situated outside the UK to be set-off against gains, either foreign chargeable gains or gains on the disposal of assets situated in the UK. Unless the election is made the foreign losses will be lost. An effect of the election is that the annual exempt amount cannot be set foreign chargeable gains remitted to the UK, section 16ZB(4). B makes a valid election within the time limit, 31 January 2017.

In 2012-13 B remits $30,000 of the $40,000 from the US bank to their UK bank where it is converted to sterling at a rate of £1 = $2.00 ie £15,000. B is not a remittance basis user in 2012-13. The rate of Capital Gains Tax is 18%. The annual exempt amount is £11,000. The remittance is a disposal of foreign currency in the US bank account giving a loss of £2,142 [$30,000 @ $2.00 = £15,000 - $30,000 @ 1.75 = £17,142].

B is liable to Capital Gains Tax in 2012-13 on the following elements.

The section 87 gain is a foreign chargeable gain. Section 12(2) and (3) TCGA provides this chargeable gain is treated as accruing in 2012-13 equal to the full amount of the gains remitted in 2012-13. B has remitted 75% of the £22,857 chargeable gain (30,000/40,000 x £22,857) = £17,142. Section 2(4) TCGA prevents the personal losses, £2,142, being set against this gain. Because of the election under s16ZA neither can the annual exempt amount be set against this part of the gain. Tax is due at 18% on £17,142 = £3,085. This tax is subject to the increase in section 91 TCGA. This is calculated by reference to the year the gain was matched ie 2010-11 not the year the gain was remitted. The rate charged, 20%, will be the same that applied to beneficiary A. The total tax charged on this part of the gain is £3,085 + £617 = £3,702.

If B had not made the election under s16ZA the annual exempt amount could be set against the remitted gains reducing the amount liable to the increase under s91. But they would lose the benefit of losses on any assets situated the UK.

Additionally for 2012-13 B has other personal gains on UK assets of £18,000. Because of the election under s16ZA the personal losses £2,142 can be set against these gains as can the annual exempt amount £11,000. With a tax rate of 18% the total tax charged on the net gains of £4,858 is £971. The total Capital Gains Tax payable for 2012-13 is £4,673 (£3,702 + £971).

38.15 Migrant settlements

38.15.1 *UK resident trust becomes non-resident*

Section 89(1) TCGA provides:

> Where a period of one or more years of assessment for which s.87 applies to a settlement ("a non-resident period") succeeds a period of one or more years of assessment for each of which s.87 does not apply to the settlement ("a resident period"), a capital payment received by a beneficiary in the resident period shall be disregarded for the purposes of sections 87 and 87A if it was not made in anticipation of a disposal made by the trustees in the non-resident period.

38.15.2 *Non-resident trust becomes UK resident*

Section 89 TCGA provides:

> (1A) Subsection (2) applies to a settlement if—
> (a) a non-resident period is succeeded by a resident period, and
> (b) in relation to the last tax year in the non-resident period ("the last non-resident tax year"), s.87A(3) applied by virtue of para (a) of that provision (exhaustion of capital payments).[21]
>
> (2) Chargeable gains are treated as accruing in a tax year (in the resident period) to a beneficiary of the settlement who receives a capital payment from the trustees in that year if all or part of the capital payment is matched (under s.87A as it applies for that year) with the s.2(2) amount for the last non-resident tax year or any earlier tax year.
>
> (3) Section 87(3) and (4) and ss.87A to 87C apply for the purposes of subsection (2) as if—
> (a) the relevant tax year were the tax year mentioned in subsection (2),
> (b) the s.2(2) amount for any tax year after the last nonresident tax year were nil, and
> (c) references in s.87A(4) to s.87 included references to s.89(2).

21 See 38.9.3 (when to stop).

(4) Section 87B (remittance basis) applies in relation to chargeable gains treated under subsection (2) as accruing as it applies in relation to chargeable gains treated under s.87 as accruing.

38.16 Four basic strategies for the s.87 charge

In outline the position is as follows:

38.16.1 *Indefinite deferral*

Beneficiaries are only liable to the s.87 charge if they receive a capital payment. But there may be no need for a capital payment to be made. Instead, the capital of the trust fund may be retained. The beneficiaries of the settlement would enjoy a trust fund unreduced by the burden of CGT. In this way the charge may be postponed until further tax planning becomes possible – or indefinitely.

38.16.2 *Non-resident beneficiary*

Section 2(2) amounts are treated as chargeable gains accruing to a beneficiary who receives capital payments. But a beneficiary who is neither resident nor ordinarily resident in the UK is not subject to CGT on those gains. Such a beneficiary may therefore receive capital payments from the trust tax free, just as he can realise capital gains of his own without incurring any tax charge. The temporary non-residence rules need to be considered, see 8.1 (Temporary non-residence).

38.16.3 *Mixed UK and foreign beneficiaries: simple capital payments*

Section 2(2) amounts which have been matched with a capital payment to a beneficiary in an earlier tax year cease to be available for the purpose of the s.87 charge in the following year. This principle applies whether or not the beneficiary was subject to the s.87 charge. Suppose that s.2(2) amounts are matched with capital payments to a non-resident beneficiary and the capital payments equal the total s.2(2) amounts. Those s.2(2) amounts are sometimes said to have been "washed". In subsequent tax years these are not taken into account and a capital payment may be made to a UK beneficiary without incurring any tax charge under s.87. Careful timing is essential. The payment to the exempt beneficiary must be made in one tax year and the payment to a UK beneficiary must be postponed until the following tax year. Section 2(2) amounts accruing in a subsequent tax year may be taxed on the UK beneficiary.

38.16.4 *Mixed UK and foreign beneficiaries: capital payment and resettlement*

If one or more of the beneficiaries of the settlement are not UK resident, the trustees might consider advancing trust capital to those beneficiaries absolutely. The beneficiaries might then independently resettle the property and may gain additional inheritance tax advantages. The CGT position would be substantially improved for the other beneficiaries by washing s.2(2) amounts equal to the advancement. But successfully implementing arrangements of this kind is easier said than done. See 58.34 (Planning to create trust with foreign domiciled settlor).

38.17 Transfer between trusts

Section 90(1) TCGA provides:

> This section applies if the trustees of a settlement transfer all or part of the settled property to the trustees of another settlement ("the transferee settlement").

In short, s.90 applies on a transfer between trusts.

The section only applies on a transfer of trust capital: if trustees of a discretionary trust distribute trust income to another trust, it is suggested that s.90 does not apply, because the income is not "settled property".

Section 90 TCGA provides:

> (3) Treat the s.2(2) amount for the transferee settlement for any tax year (not later than the year of transfer)[22] as increased by—
> (a) the s.2(2) amount for the transferor settlement for that year (as reduced under s.87A as it applies in relation to that settlement for the year of transfer and all earlier tax years), or
> (b) if part only of the settled property is transferred, the relevant

22 Section 90(2) TCGA gives this term a commonsense definition: "In this section "the year of transfer" means the tax year in which the transfer occurs."

> proportion of the amount mentioned in para (a).
>
> (4) "The relevant proportion" is—
>
> (a) the market value of the property transferred, divided by
>
> (b) the market value of the property comprised in the transferor settlement immediately before the transfer.

Section 90(5) TCGA provides corresponding relief for the transferor settlement:

> Treat the s.2(2) amount for the transferor settlement for any tax year as reduced by the amount by which the s.2(2) amount for the transferee settlement for that year is increased under subs.(3).
>
> ...
>
> (7) The increase under subs.(3) has effect for the year of transfer and subsequent tax years.
>
> (8) The reduction under subs.(5) has effect for tax years after the year of transfer.

It is interesting to compare the technique of s.81 IHTA (deeming transferred property to remain in the original trust). While that is not without its problems, it is a more effective anti-avoidance rule. The reason may be that s.90 is not (or not just) an anti-avoidance provision. It is intended to facilitate inter-trust transfers. Such transfers may be desirable for family reasons or to avoid unfairness which otherwise follows from the operation of s.87. Suppose trustees hold a trust fund worth £2m with s.2(2) amounts of £1m and they wish to make a capital payment of £1m to beneficiary A. If they do so then a subsequent distribution to beneficiary B would be tax free, and that would not be fair as between A and B. A transfer of one half of the trust fund to a separate trust, followed by a capital payment to A, solves this unfairness: A pays tax on one half of the s.2(2) amounts and B in due course may pay tax on the other half.

Section 90(6) TCGA deals with a transfer to a UK resident settlement:

> If neither s.87 nor s.89(2) would otherwise apply to the transferee settlement for the year of transfer—
>
> (a) s.89(2) to (4) apply to the settlement for that year (and subsequent tax years), and
>
> (b) for this purpose, references there to the last non-resident tax year are to be read as the year of transfer.

Amended as s.90(6) directs, s.89(2) to (4) provides:

> (2) Chargeable gains are treated as accruing in a tax year (in the resident period) to a beneficiary of the settlement who receives a capital payment from the trustees in that year if all or part of the capital payment is matched (under section 87A as it applies for that year) with the section 2(2) amount for the ~~last non-resident tax year~~ *year of transfer* or any earlier tax year.
> (3) Section 87(3) and (4) and sections 87A to 87C apply for the purposes of subsection (2) as if the relevant tax year were the tax year mentioned in subsection (2).
> (4) Section 87B (remittance basis) applies in relation to chargeable gains treated under subsection (2) as accruing as it applies in relation to chargeable gains treated under section 87 as accruing.

Section 90(9) TCGA deals with valuation:

> When calculating the market value of property for the purposes of this section or s.90A in a case where the property is subject to a debt, reduce the market value by the amount of the debt.

A transfer between trusts triggers the deadline for a rebasing election.[23]

38.17.1 *Transfer for consideration*

Section 90A TCGA provides:

> (1) Section 90 does not apply to a transfer of settled property made for consideration in money or money's worth if the amount (or value) of that consideration is equal to or exceeds the market value of the property transferred.
> (2) The following provisions apply if—
> (a) s.90 applies to a transfer of settled property made for consideration in money or money's worth, and
> (b) the amount (or value) of that consideration is less than the market value of the property transferred.
> (3) If the transfer is of all of the settled property, for the purposes of s.90 treat the transfer as being of part only of the settled property.

23 See 38.26.4 (Rebasing election).

(4) Deduct the amount (or value) of the consideration from the amount of the market value referred to in s.90(4)(a).

Section 90 does not apply to a loan from trust 1 to trust 2 on commercial terms. It does not apply to an interest free loan repayable on demand, because the promise to repay is full consideration.

38.17.2 *Other exceptions*

Section 90(10) TCGA provides:

> This section does not apply to—
> (a) a transfer to which Schedule 4B applies, or
> (b) any s.2(2) amount that is in a Schedule 4C pool (see para 1 of Schedule 4C).

These wonderfully complex anti-avoidance provisions are not discussed here.

38.18 Non-resident companies held by trustees

There is in principle no CGT advantage to be gained by transferring trust assets to a company the shares of which are held by trustees on the terms of their settlement. Gains accruing to such a company are normally attributed to the trustees and constitute s.2(2) amounts.[24] In addition, there may be a chargeable gain when the offshore trustees dispose of the company's shares. The use of the company may therefore double the potential CGT charges.

38.19 1981 transitional relief

Para 116 Sch 7 FA 2008 provides:

> For the purposes of sections 87 and 87A of TCGA 1992, no account is to be taken of—
> (a) any capital payment received before 10 March 1981, or

24 See 39.1 (Gains of non-resident companies).

(b) any capital payment received on or after that date but before 6 April 1984, so far as it represents a chargeable gain which accrued to the trustees before 6 April 1981.

All capital payments before 10 March 1981 are disregarded. Capital payments before 6 April 1984 are disregarded if they represent a chargeable gain which accrued to the trustees before 6 April 1981. How does one decide whether a capital payment represents a pre-1981 gain? Fortunately this problem will not often arise now.

38.20 1998 transitional rules

Para 118 Sch 7 FA 2008 provides:

(1) This paragraph applies if—
- (a) s.87 of TCGA 1992 applies to a settlement for the tax year 2008-09 or any subsequent tax year ("the tax year"),
- (b) the settlement was made before 17 March 1998,
- (c) none of the settlors fulfilled the residence requirements when the settlement was made, and
- (d) none of the settlors fulfils the residence requirements in the tax year.

(2) For the purposes of that section as it applies to the settlement for the tax year, no account is to be taken of—
- (a) any gains or losses accruing to the trustees of the settlement before 17 March 1998, or
- (b) any capital payments received before that date.

(3) A settlor "fulfils the residence requirements" when the settlor is—
- (a) resident or ordinarily resident in the UK, and
- (b) domiciled in any part of the UK.

I refer to this as "**1998 transitional relief**". In principle, (inter alia) for foreign domiciled settlor settlements, one disregards gains and capital payments before 17 March 1998. But if in any year there is *a* UK resident and domiciled settlor, the relief is lost in that year. Thus, the "tainting" principle applies. A small, even nominal contribution from a UK resident and domiciled settlor will forfeit the relief for all years that that settlor is UK resident and domiciled.

38.21 2008 transitional rules – Summary

EN FB 2008 summarises the matter this way:

> 440. The overall effect of these new rules is that: ...
> [1] there will be no charge to tax in respect of capital payments made to non-UK domiciled beneficiaries who:
> [a] receive capital payments before 6 April 2008 that are matched to trust gains accruing on or after 6 April 2008;[25] or
> [b] receive capital payments on or after 6 April 2008 that are matched to trust gains accruing before 6 April 2008.[26]
> This will be so irrespective of whether the non-UK domiciled beneficiary is a remittance basis user;
> [2] trustees of non-UK resident trusts will be given an option to rebase trust assets to the market value as at 6 April 2008 so that the element of trust gains relating to the period prior to 6 April 2008 will not be chargeable if matched to capital payments made on or after 6 April 2008 to non-UK domiciled beneficiaries. ... The rebasing will apply to disposals of assets of underlying companies in respect of gains attributed to the trustees under s.13(10) of TCGA.[27]

38.22 Pre-2008 s.2(2) amounts

Para 120 Sch 7 FA 2008 provides:

> (1) This paragraph applies to a settlement if s.87 or s.89(2) of TCGA 1992 applied to it for the tax year 2007–08 or any earlier tax year.
> (2) The following steps are to be taken for the purposes of calculating the s.2(2) amount for the settlement for the tax year 2007-08 and earlier tax years.
> *Step 1*
> Calculate (in accordance with s.87 and, where appropriate, s.88) the s.2(2) amount for the settlement for the tax year 2007-08 and earlier tax years.
> For this purpose, references in s.87(4) and (5) of TCGA 1992 (as substituted) to s.87 of that Act applying to a settlement for a tax year are

25 See 38.24 (Pre-2008 capital payments).
26 See 38.22 (Pre-2008 s.2(2) amounts) and 38.26 (Pre-2008 capital payments and pre-2008 s.2(2) amounts).
27 See 38.26.3 (Rebasing).

to be read as references to s.87 of that Act (as it had effect before that substitution) applying to a settlement for a tax year.

Step 2

Find the total amount of chargeable gains treated under s.87 or 89(2) as accruing to beneficiaries of the settlement in the tax year 2007-08 or any earlier tax year ("the total deemed gains").

Step 3

Find the earliest tax year for which the s.2(2) amount is not nil.

If the s.2(2) amount for that year is less than or equal to the total deemed gains, reduce that s.2(2) amount to nil.

Otherwise, reduce that s.2(2) amount by the amount of the total deemed gains.

Step 4

Reduce the total deemed gains by the amount by which the s.2(2) amount was reduced under Step 3.

Step 5

If the total deemed gains is not nil, start again at Step 3.

For this purpose, read references to the earliest tax year for which the s.2(2) amount is not nil as references to the earliest tax year—

(a) which is after the last tax year for which Steps 3 and 4 have been undertaken, and
(b) for which the s.2(2) amount is not nil.

EN FB 2008 provides an example:

60. Example: determining the s.2(2) amount for years preceding 2008-09:

The s.2(2) amounts of a settlement were:

2004-05: £100,000
2005-06: £50,000
2006-07: £200,000
2007-08: £200,000

Total deemed gains were £450,000.

a. Subtract the s.2(2) (£100,000) amount for the earliest year from the total deemed gains. Section 2(2) amount for 2004-05 reduces to nil. Total deemed gains reduced to £350,000.

b. Subtract the s.2(2) (£50,000) amount for the next earliest year from the total deemed gains carried forward. Section 2(2) amount for 2005-06 reduces to nil. Total deemed gains reduced to £300,000.

c. Subtract the s.2(2) (£200,000) amount for the next earliest year from the total deemed gains carried forward. Section 2(2) amount for 2006-07 reduces to nil. Total deemed gains reduced to £100,000.

d. Subtract the s.2(2) (£200,000) amount for the next earliest year from the total deemed gains carried forward. Section 2(2) amount for 2007-08 reduces to £100,000. Total deemed gains reduced to nil.
The s.2(2) amount for the settlement for 2007-08 is therefore £100,000.

Para 120(3) provides for Schedule 4B cases, though the drafter does not try very hard:

> If, before 6 April 2008, the trustees of the settlement made a transfer of value to which Schedule 4B to TCGA 1992 applied, sub-para (2) has effect subject to such modifications as are just and reasonable on account of Schedule 4C to that Act having applied in relation to the settlement.

38.22.1 *Pre-2008 OIG amounts*

Para 99 Sch 7 FA 2008 applies the same rule to OIG amounts:

> Paragraphs 120 and 121 apply in relation to offshore income gains as if—
> (a) references to section 2(2) amounts were to OIG amounts,
> (b) references to chargeable gains were to offshore income gains, and
> (c) Step 1 of paragraph 120(2) provided that OIG amounts are to be calculated in accordance with—
> (i) section 762(2) of ICTA (the reference in the second sentence of that Step to section 87(4) of TCGA 1992 being read as a reference to section 762(2) of ICTA), or
> (ii) section 87(5) of TCGA 1992 as applied by section 762(3) of ICTA.

38.23 Pre-2008 inter-trust transfer

Para 120(4) Sch 7 FA 2008 disapplies the rules in para 120 where there was an inter-trust transfer before 2008/09[28] and para 121 Sch 7 FA 2008

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28 Para 120(4) provides:

> This paragraph does not apply if s.90 of TCGA 1992 applied to a transfer of settled property by or to the trustees of the settlement that was made before 6 April 2008 (see para 121).

sets out its own set of rules:

> (1) If s.90 of TCGA 1992 (as originally enacted) applied to a transfer of settled property made before 6 April 2008, this paragraph applies in relation to the transferor settlement and the transferee settlement.
> (2) In this paragraph "the year of transfer" means the tax year in which the transfer occurred.
> (3) The following steps are to be taken for the purpose of calculating the s.2(2) amount for the transferor and transferee settlements for the tax year 2007-08 and earlier tax years.
> *Step 1*
> Take the steps in para 120(2) for the purpose of calculating the s.2(2) amount (at the end of the year of transfer) for the transferor settlement for the year of transfer and earlier tax years.
> For this purpose, read references there to the tax year 2007-08 as references to the year of transfer.
> *Step 2*
> Take the steps in para 120(2) for the purpose of calculating the s.2(2) amount (before the year of transfer) for the transferee settlement for the tax year before the year of transfer and earlier tax years.
> For this purpose, read references there to the tax year 2007-08 as references to the tax year before the year of transfer.
> *Step 3*
> Calculate the s.2(2) amount for the transferee settlement for the year of transfer.
> *Step 4*
> Treat the s.2(2) amount for the transferee settlement for the year of transfer or any earlier tax year (as calculated under Step 2 or 3) as increased by—
> (a) the s.2(2) amount for the transferor settlement for that year (as calculated under Step 1), or
> (b) if part only of the settled property was transferred, the relevant proportion of the amount mentioned in para (a).
> "The relevant proportion" here has the same meaning as in s.90(4) of TCGA 1992 (as substituted by this Schedule).
> *Step 5*
> Treat the s.2(2) amount for the transferor settlement for any tax year as reduced by the amount by which the s.2(2) amount for the transferee settlement for that year is increased under Step 4.
> *Step 6*
> Take the steps in para 120(2) for the purpose of calculating the s.2(2) amount for the transferor settlement for the tax year 2007-08 and earlier tax years.
> For this purpose—
> (a) treat the s.2(2) amount for the year of transfer or any earlier tax year as the amount calculated by taking Steps 1 and 5 above, and
> (b) reduce the total deemed gains by the amount of the total deemed gains calculated by taking Step 1 above.

Step 7
Take the steps in para 120(2) for the purpose of calculating the s.2(2) amount for the transferee settlement for the tax year 2007-08 and earlier tax years.
For this purpose—
(a) treat the s.2(2) amount for the year of transfer or any earlier tax year as the amount calculated by taking Steps 2 to 4 above, and
(b) reduce the total deemed gains by the amount of the total deemed gains calculated by taking Step 2 above.

The drafter felt he should do something about multiple transfers, and Sch 4B, but did not know what:

(4) This paragraph applies with any necessary modifications in relation to a settlement as respects which more than one relevant transfer was made.
(5) In sub-para (4) "relevant transfer" means a transfer—
(a) made before 6 April 2008, and
(b) to which s.90 of TCGA 1992 applied.
(6) If, before 6 April 2008, the trustees of the transferor or transferee settlement made a transfer of value to which Schedule 4B to TCGA 1992 applied, this paragraph has effect subject to such modifications as are just and reasonable on account of Schedule 4C to that Act having applied in relation to the settlement.

Para 99 Sch 7 FA 2008[29] applies the same rules for OIG amounts.

38.24 Pre-2008 capital payments

Para 122 Sch 7 FA 2008 provides:

(1) If all of a capital payment would (in the tax year 2008-09) have been left out of account by virtue of s.87(6) of TCGA 1992 as originally enacted, the amount of that capital payment is reduced to nil.
(2) If part of a capital payment would (in the tax year 2008-09) have been left out of account by virtue of s.87(6) of TCGA 1992 as originally enacted, the amount of that capital payment is reduced by the amount of that part.
(3) If—
(a) chargeable gains were treated under s.87 or 89(2) of, or para 8 of Schedule 4C to, TCGA 1992 as accruing in the tax year 2007-08 or any earlier tax year to a beneficiary,
(b) more than one capital payment that the beneficiary had

29 Set out at 38.22.1 (Pre-2008 OIG amounts).

received was taken into account for the purposes of determining the amount of chargeable gains treated as accruing to the beneficiary, and

(c) the amount of those chargeable gains was less than the total amount of capital payments taken into account,

for the purposes of this paragraph treat s.87(6) of TCGA 1992 as originally enacted as having effect in relation to earlier capital payments before later ones.

(4) References in this paragraph to s.87(6) of TCGA 1992 include that provision as it would (but for the amendments made by this Schedule) have applied by virtue of s.762(3) of ICTA (offshore income gains).

(5) References in this paragraph to chargeable gains include offshore income gains.

38.25 Pre-2008 trust immigration

Para 123 Sch 7 FA 2008 provides:

> Section 89(2) of TCGA 1992 as substituted applies to a settlement for the tax year 2008-09 (and subsequent tax years) if s.89(2) of that Act as originally enacted would (but for the amendments made by this Schedule) have applied to the settlement for the tax year 2008-09.

What is the reason for this?

38.26 Pre-2008 capital payments and pre-2008 s.2(2) amounts

Para 124 Sch 7 FA 2008 provides:

> (1) This paragraph applies if—
>
> (a) chargeable gains are treated under s.87 or 89(2) of TCGA 1992 as accruing to an individual in the tax year 2008-09 or any subsequent tax year, and
>
> (b) the individual is not domiciled in the UK in that year.
>
> (2) The individual is not charged to capital gains tax on the chargeable gains if and to the extent that they are treated as accruing by reason of—
>
> (a) a capital payment received (or treated as received) by the individual before 6 April 2008, or
>
> (b) the matching of any capital payment with the s.2(2) amount for the tax year 2007-08 or any earlier tax year.

Para (2)(a) provides relief for pre-2008/09 capital payments to foreign domiciliaries. Para (2)(b) provides relief for capital payments matched with pre-2008/09 s.2(2) amounts.

FAQ Residence & Domicile – NR Trusts provides:

> **Gains of offshore trustees that are realised before 6 April 2008 will not be taxed on non-domiciled beneficiaries. So does that mean that gains realised prior to 6 April 2008 will not produce a tax charge under s.87 TCGA if matched to capital payments made toa non domiciled beneficiary after 5 April 2008?**
> Yes, so long as the beneficiary remains domiciled outside the UK it does not matter that he/she has not made a claim for the remittance basis to apply at the time of the capital payment, provided that such payment is matched to pre 6 April 2008 gains. By pre 6 April 2008 gains we mean gains that were actually realised before 6 April 2008 or, if a rebasing election has been made, those gains which represent the pre 6 April 2008 element. However, if the capital payment made on or after 6 April 2008 is matched under Last In First Out Rules (LIFO) to gains realised on or after 6 April 2008 (or the post 5 April element of such gains where a rebasing election has been made), then the payment will be taxable (on a remittance basis if the beneficiary is a remittance basis user and otherwise on an arising basis).
> **Capital payments made to non domiciled beneficiaries before 6 April 2008 will not be taxed. So does this mean that capital payments made to the UK before 6 April 2008 will not produce a tax charge under s.87 TCGA when matched to gains realised by the offshore trustees after 5 April 2008?**
> Yes so long as the non domicile is still not domiciled in the UK under general law in the year of charge. It will not be necessary for the beneficiary to be a remittance basis user if post 5 April gains are matched to capital payments made prior to 6 April 2008. There are however special rules to deal with matching of post 5 April 2008 trust gains to capital payments made between 12 March and 5 April 2008 inclusive.

38.26.1 *Pre-2008 capital payments and pre-2008 OIG amounts*

Para 100 Sch 7 FA 2008 provides the same rules for OIG amounts:

> (1) This paragraph applies if—
> (a) by virtue of section 87 or 89(2) of, or Schedule 4C to, TCGA

1992 as applied by section 762 of ICTA, income is treated under section 761 of ICTA as arising to an individual in the tax year 2008–09 or any subsequent tax year, and

(b) he individual is not domiciled in the United Kingdom in that year.

(2) The individual is not charged to income tax on the income if and to the extent that it is treated as arising by reason of—

(a) a capital payment received (or treated as received) by the individual before 6 April 2008, or

(b) the matching of any capital payment with the OIG amount for the tax year 2007–08 or any earlier tax year.

38.26.2 *Capital payments between 12 March and 5 April 2008*

Para 125 Sch 7 FA 2008 provides a special rule for these capital payments:

> (1) This paragraph applies in relation to a settlement for the tax year 2008-09 or any subsequent tax year ("the relevant tax year") if—
>
> (a) an individual who was resident or ordinarily resident, but not domiciled, in the UK in the tax year 2007-08 received a capital payment from the trustees of the settlement on or after 12 March 2008 but before 6 April 2008, and
>
> (b) the individual is resident or ordinarily resident, but not domiciled, in the UK in the relevant tax year.
>
> (2) For the purposes of sections 87 to 89 of TCGA 1992 as they apply in relation to the settlement for the relevant tax year, no account is to be taken of the capital payment.

One might refer to capital payments made between 12 March and 5 April 2008 as post-budget 2008 capital payments. There is no matching for post-budget 2008 capital payments, so such payments do not reduce s.2(2) amounts.

January 2009 Qs & As provides:

> **Q4**: Paragraph 125(2) appears to disregard payments between 12 March and 5 April altogether, which is different to the treatment proposed in the Budget documentation published on 12 March.
>
> **A**: The original intention set out in the Budget documentation of 12 March and legislation was to allow the matching of capital payments between 12 March 2008 and 5 April 2008 with any gains relating to the

period up to 5 April 2008 arising to the trustees after 5 April 2008. However, this proposal was dropped because it would have introduced additional and unnecessary complexity to the legislation.

38.26.3 Rebasing

Paragraph 126 Sch 7 FA 2008 provides a relief which I call "**rebasing**". HMRC s.87 guidance note provides a summary:

> 79. Paragraph 126 of Schedule 7 is a transitional rule which may benefit UK resident but non-domiciled beneficiaries of non resident trusts in existence at 6 April 2008. The paragraph allows the trustees to make an election which restricts the section 87 gain charged on the beneficiary to the growth in the value of the assets from 6 April 2008. The election is irrevocable and applies to all the assets whose disposal creates a section 2(2) amount. It cannot increase the tax payable by a beneficiary. Whether it improves the position of the beneficiary depends on the history of the assets disposed of. It is not possible to make the election only in respect of assets which have increased in value since 6 April 2008.
> 80. The election is commonly known as a "rebasing" election and that is how it will be described in this article. But it is not rebasing as that term applies to section 35 TCGA and assets held at 31 March 1982. There is no across the board revaluation of the assets in the trust fund as at 6 April 2008.
> 81. The election has no effect on the matching of capital payments to section 2(2) amounts or the reduction of capital payments and section 2(2) amounts. It has no effect on gains accruing to UK domiciled beneficiaries.

38.26.4 *Rebasing election*

Para 126 provides:

> (1) The following provisions apply to a settlement if—
> (a) s.87 applies to the settlement for the tax year 2008-09, and
> (b) the trustees of the settlement have made an election under this subparagraph.
>
> (2) An election under sub-para (1) may only be made on or before the first 31 January to occur after the end of the first tax year (beginning with the tax year 2008-09) in which an event within either of the

following paragraphs occurs—

(a) a capital payment is received (or treated as received) by a beneficiary of the settlement,[30] and the beneficiary is resident in the UK in the tax year in which it is received, and

(b) the trustees transfer all or part of the settled property to the trustees of another settlement, and s.90 of TCGA 1992 applies in relation to the transfer...

(5) An election under sub-para (1) is irrevocable.

(6) An election under that sub-paragraph must be made in the way and form specified by the Commissioners for Her Majesty's Revenue and Customs.

HMRC s.87 guidance note provides:

> 82. The election can be made only if the settlement was non-UK resident throughout 2008-09.

This follows from para 126(1)(a). The guidance note continues:

> Paragraph 126(1) requires that the election be made by the trustees of the settlement. It must be made by all the trustees or by a majority of them if they are permitted to act through a majority. It cannot be made by a beneficiary. If the beneficiary's Self Assessment tax return is taken up for enquiry an election may require additional disclosure to HMRC about assets held by the trustees in order to agree the valuation.
>
> 83. The relief is given only to individuals, paragraph 126(7), but the time limit is triggered if a capital payment is received by any UK resident beneficiary.

A benefit within s.731 is not a capital payment so does not trigger the deadline for an election.

EN FB 2008 provides:

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30 Para 126 expands on this in Sch 4C cases:

"(3) For a tax year as respects which the settlement has a Schedule 4C pool, the reference in sub-para (2)(a) above to a capital payment received (or treated as received) by a beneficiary of the settlement is to be read as a capital payment received (or treated as received) by a beneficiary of a relevant settlement from the trustees of a relevant settlement.

(4) Para 8A of that Schedule (relevant settlements) applies for the purposes of sub-para (3) above."

> 63. The provisions of para [126] are subject to an election rather than being mandatory because:
> [1] depending on the assets comprised in the settlement as at 6 April 2008 it may not be advantageous for the paragraph to apply; and
> [2] the trustees will be required to provide additional information to HMRC about trust assets. Trustees of non-resident settlements have been assured in a letter from the Acting Chairman of HMRC, Dave Hartnett, dated 12 February 2008 that in applying the provisions set out in this Schedule, HMRC will not require any additional disclosure.

As far as [1] is concerned, I am unable see how it could not be advantageous for para 126 to apply. Subject to point [2] (confidentiality) an election should be made in every case. The December 2008 Qs & As provide:

> The earliest deadline for trustees to make an election for rebasing will be 31 January 2010 where a trigger such as a capital payment is made to a UK resident beneficiary in 2008-09 or the trustees transfer property in another settlement.

The HMRC s.87 guidance note provides:

> 87. An election may be made before a triggering event happens. There is no requirement that the beneficiary receiving the payment was a beneficiary of the settlement as at 6 April 2008. The recipient may become a beneficiary at some later time. The time limit in paragraph 126(2) of Schedule 7 runs from the time the trustees first make a capital payment to a UK resident beneficiary. If the trustees make such a payment and do not make the election they may be out of time for making the election if they make a payment to a UK-resident but non-domiciled beneficiary at a later time. The election can be made even if there are no non-UK domiciled beneficiaries when the payment is made.
> 88. Any election made late will be considered in accordance with the guidance in paragraph 13801 onwards in HMRC's Capital Gains Tax manual.
> 89. The election must be made in the way and form specified by HMRC, paragraph 126(6). HMRC have provided a form RBE1 to satisfy this requirement and all elections must be made on that form. The form asks for the name of the settlement and the date it was created. The date is used to distinguish between settlements with similar names in particular

those created by settlors with a prevalent surname. The form also asks the trustees to identify if and when a trigger event has occurred. The RBE1 can be downloaded from the HMRC website[31] or can be ordered by phoning HM Revenue and Customs CAR Residency on 0151 472 6384 or +44 151 472 6384 if you are calling from abroad. 90. Some trustees may have made the election by writing to CAR Residency before the form was available. That election remains valid and there is no need to make a further election on the form.

38.26.5 *The relief*

Para 126 Sch 7 FA 2008 provides:

> (7) Sub-para (8) applies if—
> (a) by virtue of the matching of a capital payment with the s.2(2) amount for the settlement for the tax year 2008-09 or any subsequent tax year ("the relevant tax year"), chargeable gains are treated under s.87 or 89(2) of, or para 8 Schedule 4C to, TCGA 1992 as accruing to an individual in a tax year, and
> (b) the individual is resident, but not domiciled, in the UK in that year.
> (8) The individual is not charged to capital gains tax on so much of the chargeable gains as exceeds the relevant proportion of those gains.

FAQ Residence & Domicile – NR Trusts provides:

> The rebasing simply (?) means that trustees will need to keep a record of the pre 6 April 2008 element of any gain realised on a disposal to work out whether a capital payment made to a non domiciled beneficiary on or after 6 April 2008 is taxable. To the extent that pre 6 April 2008 gains are matched to post 6 April capital payments they are not taxable.

38.26.6 *Relevant proportion*

Para 126(9) Sch 7 FA 2008 provides:

> The relevant proportion is A÷B where—
> A is what would be the s.2(2) amount for the settlement for the relevant

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31 Accessible *www.hmrc.gov.uk/cnr/rbe1.pdf.*

tax year, if immediately before 6 April 2008 every relevant asset had been sold by the trustees (or the company concerned) and immediately re-acquired by them (or it) at the market value at that time, and
B is the s.2(2) amount for the settlement for the relevant tax year.

38.26.7 *Relevant asset*

Para 126(10) provides:

> For the purposes of sub-para (9) an asset is a "relevant asset" if—
> (a) by reason of the asset, a chargeable gain or allowable loss accrues to the trustees in the relevant tax year, and
> (b) the asset has been comprised in the settlement from the beginning of 6 April 2008 until the time of the event giving rise to the chargeable gain or allowable loss.

HMRC s.87 guidance provides:

> 97. You consider only the assets whose disposal gave rise to the section 2(2) amount. Any assets held at 6 April 2008 which are not disposed of are not included in the comparison. This means that assets held at 6 April 2008 need be valued only when they are disposed of.

Para 126(11) extends the relief to assets held by companies held by trusts:

> For those purposes, an asset is also a "relevant asset" if—
> (a) by reason of the asset, chargeable gains are treated under s.13 of TCGA 1992 as accruing to the trustees in the relevant tax year,
> (b) the company to whom the chargeable gains actually accrue has owned the asset from the beginning of 6 April 2008 until the time of the event giving rise to those chargeable gains, and
> (c) had the company disposed of the asset at any time in the relevant period,[32] part of the chargeable gains (if any) accruing on the disposal would have been treated under s.13 of TCGA 1992 as accruing to the trustees.

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32 Para 126(12) provides: "In sub-para (11)(c) "the relevant period" means the period beginning at the beginning of 6 April 2008 and ending immediately before the event giving rise to the chargeable gains."

An company's asset is not a relevant asset if a loss accrues on the disposal.

38.27 Rebasing - HMRC examples

EN FB 2008 provides:

> 64. It should be noted that para [126] does not affect the computation of the s.2(2) amount under s.87 for a year. It simply provides a mechanism for identifying an amount of the chargeable gain treated as accruing to a non-UK domiciled beneficiary that is not chargeable to tax because an element of the underlying s.2(2) amounts are attributable to the period before 6 April 2008, when non-UK domiciled beneficiaries were not chargeable to tax in respect of chargeable gains attributed to them under s.87.
> 65. Para [126] applies to all non-UK domiciled beneficiaries of a settlement, the trustees of which have made a valid election. The non-UK domiciled beneficiary does not need to be a remittance basis user. Only once the provisions of para [126] have been applied is it necessary to see whether the amount of tax that is left in charge is chargeable on the arising basis, in the year in which the gains are treated as having accrued to the beneficiary, or on the remittance basis where one of s.809B, [809D or 809E] applies.
> 66. Some worked examples showing how para [126] works follow. Although there is only one s.87 pool for each tax year, where an election has been made under para [126](1) trustees will need to keep track of the separate elements of gains attributed to the period before and after 6 April 2008 within the pool.
> 67. There are no special rules to deal with assets where the market value as at 6 April 2008 was either higher or lower than both the cost of acquisition of the asset and the disposal proceeds.

Example 1 is relatively straightforward.

> 68. *Example 1: basic mechanism of para [126](8)(9)]*:
> The trustees of a settlement make an election under para [126](1).
> In 2009-10 the trustees dispose of a property for £10 million. The chargeable gain accruing to the trustees is £8 million.
> The chargeable gain that would have accrued to the trustees if the gain had been computed using the market value of the property as at 6 April 2008 as the cost of acquisition is £1 million.
> The trustees make a capital payment to beneficiaries X and Y of £4 million each. X and Y are both resident in the UK but X is also domiciled in the UK whereas Y is not.
> There are no unmatched capital payments or trust gains relating to earlier years.

The HMRC analysis is as follows:

> a. Match the capital payments to the s.2(2) amount for the year. Capital payments

total £8 million and match to the s.2(2) amount of £8 million.

Chargeable gains of £4 million are treated as accruing to X and Y for 2009-10.

X is chargeable to CGT in 2009-10 under s.87 on the gains of £4 million.

Y is non-UK domiciled so para [126](1) applies to determine how much of the chargeable gains of £4 million is chargeable to tax.

b. The s.2(2) amount for 2009-10 is £8 million ("B" in para [126(9)].

c. The s.2(2) amount that would have applied if the trustees had sold the property and reacquired it immediately before 6 April 2008 is £1 million ("A" in para [126(9)].

d. A/B is 1/8.

e. Apply A/B to the chargeable gains of £4 million accruing to Y: the amount of the gains that is chargeable to tax under para [126(8)] is £4 million/8, i.e. Y is chargeable to capital gains tax on £500,000. If Y is a remittance basis user there will be no charge to tax until Y remits gain to the UK.

There are no surplus capital payments or trust gains for 2009-10.

Example 2 is more challenging.

69. *Example 2: matching capital payments across years and s.13 gains*

The trustees of a settlement make an election under para [126](1). The beneficiaries of the settlement are X, who is UK domiciled, and Y, who is not. Both X and Y are resident in the UK.

There are no unmatched trust gains or capital payments relating to earlier years.

In 2010-11 the trustees dispose of two assets:

a. the chargeable gains are £8 million: the pre 6 April 2008 gains are £7 million and the post 5 April 2008 gains are £1 million;

b. the overall loss is £5 million: the pre 6 April 2008 gain is £1 million and the post 5 April 2008 loss is £6 million.

A capital payment of £5 million is made to beneficiary Y.

In 2011-12 the trustees dispose of an asset. The chargeable gain is £5 million: the pre 6 April 2008 gain is £4 million and the post 5 April 2008 gain is £1 million.

Capital payments are made to beneficiaries X and Y of £2 million each.

In 2012-13 an underlying company within s.13 wholly owned by the trustees disposes of an asset for £5 million. The loss on the asset is £2 million.[33] But substituting the market value as at 6 April 2008 creates a post 5 April gain of £1 million. The trustees also dispose of an asset. The chargeable gain is £3 million: the pre 6 April 2008 gain is £2 million and the post 5 April 2008 gain is £1 million.

Capital payments are made to beneficiaries X and Y of £2 million each.

The EN next sets out a table to summarise these facts which for ease of

33 [Author's Note. This loss is not allowable; careful planning might have avoided that result.]

reference I set out here slightly expanded. It is easier to follow the example with the much fuller spreadsheet which is available on *www.kessler.co.uk* (not set out here because it needs an A4 sheet).

	Pre 6/4/08 gain/loss	**Post 5/4/08 gain/loss**	**"A"**	**s.2(2) amount "B"**	**A/B**	**Cap P't to X**	**Cap P't to Y**
2010-11	£8m	(£5m)	£0	£3m	0	-	£5m
2011-12	£4m	£1m	£1m	£5m	1/5	£2m	£2m
2012-13	£2m	£2m	£2m(?)	£3m	2/3(?)	£2m	£2m

The HMRC analysis is as follows:

> ***2010-11***
> The s.2(2) amount is £3 million. Match capital payment of £5 million against trust gains of £3 million: chargeable gains of £3 million treated as accruing to Y. But Y is not UK domiciled so para [126] applies.
> Only £3 million x (A÷B) of the matched capital payment is chargeable to tax. However, the s.2(2) amount based on the market value of the assets as at 6 April 2008 is £0. Therefore A÷B is zero and none of the chargeable gains treated as accruing to Y is chargeable to tax.
> 2010-11: £2 million unmatched capital payments to Y.
> ***2011-12***
> The s.2(2) amount is £5 million. Match capital payments of £4 million in the year against trust gains of £5 million; chargeable gains of £2 million treated as accruing to each of X and Y.
> There are £1 million trust gains of 2011-12 unmatched. Step 5 of s.87A(2) applies.
> Match 2011-12 £1 million trust gains to unmatched capital payments of £2 million to Y of 2010-11.
> Chargeable gains of £1 million treated as accruing to Y. Unmatched capital payment to Y of 2010-11 reduced to £1 million.
> X is chargeable to tax on £2 million in respect of 2012-13.
> Y has chargeable gains of £3 million in respect of 2012-13. But Y is not UK domiciled so para [126] applies.
> Under para [126(8)(9)]£3 million x (A÷B) of the matched capital payment is chargeable to tax.
> A÷B is 1/5 so £600,000 of the chargeable gains treated as accruing to Y in 2011-12 are taxable.
> £1 million unmatched capital payments to Y originating from 2010-11 to carry forward.
> ***2012-13***
> The s.2(2) amount is £3 million. The disposal of the asset by the underlying

company does not form part of the s.2(2) amount because only s.13 gains are brought into s.87. However, by applying the market values to the assets as at 6 April 2008 there is a gain attributable to the disposal of the asset by the company. Match the capital payments of £4 million to the s.2(2) amount. Chargeable gains are treated as accruing to X and Y of £1.5 million each under part (b) of Step 3 of s.87A(2).
X is chargeable to tax on £1.5 million in respect of 2012-13.
Y has chargeable gains of £1.5 million in respect of 2012-13. But Y is not UK domiciled so para [126] applies.
Under para [126(8)(9)], £1.5 million x (A÷B) of the matched capital payment is chargeable to tax. A÷B is 2/3 so £1 million of the chargeable gains treated as accruing to Y in 2012-13 are taxable. While the kink in the value of the company's asset has increased the proportion of gains on which Y is chargeable to tax, Y is still better off than if no election had been made.

This assumes that the company's asset is a "relevant asset". However it is not a relevant asset, as it is not the case that "by reason of the asset, chargeable gains are treated under s.13 TCGA as accruing to the trustees in the relevant tax year." The correct figure for A/B is 1/3 and not 2/3 and the taxable gains are £0.5m and not £1m.

There are £1.5m unmatched capital payments to Y to carry forward - £1m from 2010-11 and £0.5m from 2012-13.
There are £0.5m unmatched capital payments to X to carry forward all originating from 2012-13.
70. *Example 3: keeping track of pre 6 April and post 5 April gains and losses.*
The trustees of a settlement make an election under para [126](1). The beneficiaries of the settlement are X, who is UK domiciled, and Y, who is not. Both X and Y are resident in the UK. There are no unmatched trust gains or capital payments relating to earlier years.
In 2010-11 the trustees dispose of an asset. The chargeable gain is £8 million: the pre 6 April gain is £7 million and the post 5 April 2008 gain is £1 million.
A capital payment of £2 million is made to each of beneficiaries X and Y.
In 2011-12 the trustees make a further capital payment to X and Y of £2 million each.

It may be easier to follow if the facts are set out in a table:

	Pre 6/4/08 gain/loss	**Post 5/4/08 gain/loss**	**"A"**	**s.2(2) amount "B"**	**A/B**	**Cap P't to X**	**Cap P't to Y**
2010-11	£7m	£1m	£1m	£8m	1/8	£2m	£2m
2011-12	0	0	n/r	£5m	n/r	£2m	£2m

The HMRC analysis is as follows:

2010-11

The s.2(2) amount is £8 million.

Match capital payments of £4 million in the year against trust gains of £8 million: chargeable gains of £2 million treated as accruing to each of X and Y. X is chargeable to tax on £2 million in respect of 2010-11.

Y has chargeable gains of £2 million in respect of 2010-11. But Y is not UK domiciled so para [126] applies.

Under para [126(8)(9)] £2 million x (A÷B) of the matched capital payment is chargeable to tax.

A÷B is 1/8 so £250,000 of the chargeable gains treated as accruing to Y in 2010-11 are taxable.

The reduced s.2(2) amount for 2010-11 for the purposes of matching with future capital payments is £4m.

2011-12

There is no s.2(2) amount for the year. Apply s.87A matching rules to earlier year.

Match capital payments of £4 million in 2011-12 to s.2(2) amount (as reduced) for 2010-11 of £4m:

chargeable gains of £2 million treated as accruing to each of X and Y.

X is chargeable to tax on £2m in respect of 2011-12.

Y has chargeable gains of £2 million in respect of 2011-12. But Y is not UK domiciled so para [126] applies.

Under para [126(7)(8)]£2 million x (A÷B) of the matched capital payment is chargeable to tax.

A÷B is 0.5/4 so £250,000 of the chargeable gains treated as accruing to Y in 2011-12 are taxable.

The table below shows how the s.2(2) amount for the year and the underlying gains (or losses) relating to the period before and after 6 April 2008 are matched.

2010-11 matching of capital payments	**Pre 6 April gain/loss**	**Post 5 April gain/loss**	**Total trust gains (section 2(2) amount)**
2010-11	£7m	£1m	£8m
Less matched to capital payment in 2010-11	£3.5m	£500,000	£4m
Unmatched in 2010-11	£3.5m	£500,000	£4m
Less matched to capital payments in 2011-12	£3.5m	£500,000	£4m
Unmatched in 2011-12	£0	£0	£0

38.28 Rebasing - supplementary provisions

Para 126(13) Sch 7 FA 2008 extends the relief where one asset is derived from another asset; this will not be very common:

If— (a) by reason of an asset which would not otherwise be a relevant asset ("the new asset"), chargeable gains or allowable losses accrue, or are treated under s.13 as accruing, to the trustees in the relevant tax year,
(b) the value of the new asset derives wholly or in part from another asset ("the original asset"), and
(c) s.43 of TCGA 1992 applies in relation to the calculation of the chargeable gains or allowable losses,

the new asset (or part of that asset) is a "relevant asset" if the condition in sub-para (10)(b) or the conditions in sub-para (11)(b) and (c) would be met were the references there to the asset to be read as references to the new asset or the original asset.

Para 126(14)(15) extends the relief where there is an inter-group transfer:

(14) If—
(a) on or after 6 April 2008, a company ("company A") disposes of an asset to another company ("company B"), and
(b) s.171 of TCGA (transfers within groups) (as applied by s.14(2) of that Act) applies in relation to the disposal,

for the purposes of sub-para (11) (and this sub-paragraph) treat company B as having owned the asset throughout the period when company A owned it.

(15) If an asset is a relevant asset by virtue of sub-para (14), for the purposes of sub-para (9)—
(a) treat the chargeable gains as having accrued to the company which owned the asset at the beginning of 6 April 2008, and
(b) treat the proportion of those chargeable gains attributable under s.13 of TCGA 1992 to the trustees as being the proportion of the chargeable gains actually accruing that are so attributable.

Para 126(16) to (18) deals with the situation where an asset is held by a company, and the trustees have held different interests in the company at different times:

(16) If—

(a) an asset would otherwise be a "relevant asset" within sub-para (11), and
(b) the proportion of chargeable gains treated under s.13 of TCGA 1992 as accruing to the trustees by reason of the asset ("the relevant proportion") is greater than the minimum proportion,

for the purposes of sub-para (9) treat the appropriate proportion of the asset as a relevant asset and the rest of the asset as if it were not a relevant asset.

(17) "The minimum proportion" is the smallest proportion of chargeable gains (if any) that would have been attributable to the trustees on a disposal of the asset at any time in the relevant period (as defined by sub-para (12)).

(18) "The appropriate proportion" is the minimum proportion divided by the relevant proportion.

38.29 Rebasing – OIG amounts

Paragraph 101 Sch 7 FA 2008 provides equivalent rebasing relief for OIGs:

(1) This paragraph applies if—
(a) the trustees of a settlement have made an election under paragraph 126(1) (re-basing election),
(b) income is treated under section 761 of ICTA as arising to an individual in the tax year 2008–09 or any subsequent tax year ("the relevant tax year") by reason of the matching, under section 87A of TCGA 1992 as applied by section 762 of ICTA, of an OIG amount with a capital payment received by the individual from the trustees, and
(c) the individual is resident or ordinarily resident, but not domiciled, in the UK in the relevant tax year.

(2) The individual is not charged to income tax on so much of the income as exceeds the relevant proportion of that income.

(3) Sub-paragraphs (9) to (18) of paragraph 126 (meaning of "the relevant proportion") apply for the purposes of sub-paragraph (2) above as if—
(a) references to section 2(2) amounts were to OIG amounts,
(b) references to chargeable gains were to offshore income gains,
(c) references to allowable losses were omitted, and
(d) references to anything accruing were to it arising (and similar references were read accordingly).

38.30 Rebasing - transfers between trusts

Para 127(1) Schedule 7 FA 2008 provides:

This paragraph applies if—

- (a) in the tax year 2008-09 or any subsequent tax year, the trustees of a settlement ("the transferor settlement") transfer all or part of the settled property to the trustees of another settlement ("the transferee settlement"),
- (b) s.90 of TCGA 1992 applies in relation to the transfer,
- (c) the trustees of the transferor settlement have made an election under para 126(1),
- (d) by virtue of the matching of a capital payment with the s.2(2) amount for the transferee settlement for the tax year 2008-09 or any subsequent tax year ("the relevant tax year"), chargeable gains are treated under s.87 or 89(2) of, or para 8 of Schedule 4C to, TCGA 1992 as accruing to an individual in a tax year, and
- (e) the individual is resident, but not domiciled, in the UK in that year.

38.30.1 *Transferee trust makes rebasing election*

Para 127(2) Sch 7 FA 2008 provides:

If the trustees of the transferee settlement have made an election under para 126(1), para 126(7) to (9) have effect in relation to the transferee settlement for that year as if the reference in para 126(9) to relevant assets included relevant assets within the meaning of this paragraph.

38.30.2 *Transferee trust does not make rebasing election*

Para 127 Sch 7 FA 2008 provides:

(3) If the trustees of the transferee settlement have not made an election under para 126(1), the individual is not charged to capital gains tax on so much of the chargeable gains mentioned in sub-para (1)(d) above as exceeds the relevant proportion of those gains.

(4) The relevant proportion is—

where—

A is what would be the s.2(2) amount for the transferee settlement for

the relevant tax year, if immediately before 6 April 2008 every relevant asset had been sold by the company concerned and immediately re-acquired by it at the market value at that time, and
B is the s.2(2) amount for the transferee settlement for the relevant tax year.

(5) For the purposes of this paragraph an asset is a "relevant asset" if—
- (a) by reason of the asset, chargeable gains are treated under s.13 of TCGA 1992 as accruing to the trustees of the transferee settlement in the relevant tax year,
- (b) the company to whom the chargeable gains actually accrue has owned the asset from the beginning of 6 April 2008 until the time of the event giving rise to those chargeable gains,
- (c) had the company disposed of the asset at any time in the relevant period, part of the chargeable gains (if any) accruing on the disposal would have been treated under s.13 of TCGA 1992 as accruing to—
  - (i) the trustees of the transferor settlement (if the disposal had been made before the transfer), or
  - (ii) the trustees of the transferee settlement (if it had not).

(6) In sub-para (5)(c) "the relevant period" means the period beginning at the beginning of 6 April 2008 and ending immediately before the event giving rise to the chargeable gains.

(7) Sub-paras (13) to (18) of para 126 apply for the purposes of this paragraph (with such modifications as are necessary) as they apply for the purposes of that paragraph.

January 2009 Qs & As provides:

Q7 In applying the allocation rules to transfers between settlements, the transferor trust gains carried across will be treated as having accrued to the transferee trust in the year in which they in fact accrued to the transferor trust. Those gains that have been matched with capital payments out of transferor trust in the year of transfer or previous years will be left out of account. Gains carried across will be allocated to a capital payment from the transferee trust on a 'last in first out' (LIFO) basis. Gains on such assets will be governed by whether or not the transferor trust has made a rebasing election under paragraph 126 sch 7 FA 2008.

If the transferor settlement has made a rebasing election by the time of the transfer of the transferee settlement, then pre and post April 2008 gains which are deemed to have accrued on the actual disposal of an asset go across *pro rata*.

If the transferor settlement has not made a rebasing election by the 31 January following the year of the transfer, then even if no capital payment has yet been made, the right to rebase is lost in relation to the transferred assets and any assets retained in the transferor trust.

However, it should be noted that any transfers between settlements made prior to 6 April 2008 will not trigger a time limit on rebasing and any assets moving over to the transferee settlement as a result of a transfer made prior to 6 April 2008 will not be affected by any subsequent election for rebasing made by the transferor trust. If the asset appointed over to the transferee settlement before 6 April 2008 includes shares in a company within s.13 TCGA 1992, then the transferee settlement may wish to elect for rebasing in its own right. An election made by the transferee settlement may cover gains made by such a company – see para 127 Sch 7 FA 2008. Transferee settlements which receive property on or after 6 April 2008 cannot elect for rebasing in relation to the transferred assets – the decision is solely that of the transferor settlement.

Example

Trust 1 –- £300,000 gains made

Capital payment made of £10,000 to a remittance basis user.

Election for rebasing made: 90% (£270,000) of gains relate to the period pre 6 April 2008 and 10% (£30,000) post 5 April 2008.

The capital payment is matched only to post 5 April 2008 gains and taxed on remittance basis. £290,000 gain carried forward (£270,000 pre 6 April and £20,000 post 5 April 2008). So now 6.90% is post 5 April 2008 gain and 93.10% is pre 6 April 2008 gain.

Trust 1 appoints cash to Trust 2 of £2.5m at a time when Trust 1 is worth £20m (i.e. 12.5% of fund). £36,250 gains are transferred to Trust 2 (12.5% of £290,000). 93.1% of these relate to the period pre 6 April 2008 and 6.9% after.

Trust pool in Trust 1 reduced to £253,750 (93.1% pre 6 April and 6.9% post 5 April 2008).

38.30.3 *Transfer between trusts: OIG amounts*

Para 102 Sch 7 FA 2008 provides equivalent rules for OIG amounts:

(1) This paragraph applies if—

(a) in the tax year 2008–09 or any subsequent tax year, the trustees of a settlement ("the transferor settlement") transfer all or part of the settled property to the trustees of another settlement ("the transferee settlement"),

(b) section 90 of TCGA 1992 applies in relation to the transfer,

(c) the trustees of the transferor settlement have made an election under paragraph 126(1),

(d) by virtue of the matching (under section 87A of TCGA 1992 as applied by section 762 of ICTA) of a capital payment with an OIG amount of the transferee settlement, income is treated under section 761 of ICTA as arising to an individual in a tax year ("the relevant tax year"), and

(e) the individual is resident or ordinarily resident, but not domiciled, in the United Kingdom in the relevant tax year.

(2) If paragraph 101 applies in relation to the transferee settlement, paragraph 126(9) as applied by paragraph 101(3) has effect as if the reference there to relevant assets included relevant assets within the meaning of paragraph 127(4) (as modified by sub-paragraph (4)(b) below).

(3) If paragraph 101 does not apply in relation to the transferee settlement, the individual is not charged to income tax on so much of the income mentioned in sub-paragraph (1)(d) above as exceeds the relevant proportion of that income.

(4) Sub-paragraphs (4) to (7) of paragraph 127 (meaning of "the relevant proportion") apply for the purposes of sub-paragraph (3) above as if—

(a) references section 2(2) amounts were to OIG amounts,

(b) references to chargeable gains were to offshore income gains, and

(c) references to anything accruing were to it arising.

38.31 Role of non-resident trusts from 2008

Non-resident trusts may be useful where:

(1) s.86 TCGA does not apply;

(2) Trust holds:

  (a) UK situate property; or

  (b) Companies within s.13 TCGA which hold UK situate property.

For if the trust property is held by beneficiaries directly, disposals of the UK situate property are chargeable on an arising basis; if the same property is held on a trust, disposals by the trustees are taxable on a capital payments basis.

CHAPTER THIRTY NINE

GAINS OF NON-RESIDENT COMPANIES

39.1 Section 13 TCGA – Introduction

Non-resident companies generally pay no UK tax on chargeable gains. This presents an obvious means of CGT avoidance. HMRC's first answer to this is s.13 TCGA. The same problems arise for income of non-resident companies and for income and gains of non-resident trusts, but the statutory solutions are entirely different.

Section 13(1) TCGA provides:

> This section applies as respects chargeable gains accruing to a company—
> (a) which is not resident in the UK, and
> (b) which would be a close company if it were resident in the UK.

For the definition of close company see 63.15 (Definition of "close company"). In this chapter when I refer to a company I assume it is close (or that it would be close if UK resident).

For s.13 deemed gains accruing to charities, see Taxation of Charities, 7th ed. (Kessler and Brown) para 3.7. For gains accruing to offshore unit trusts, see 27.3 (Gains accruing to unit trust). For gains accruing in the year of arrival and departure see 6.16.1 (Section 13). For double taxation relief see 41.11 (DTT relief: s.13 TCGA).

39.2 Attribution of gains to participator

Section 13(2) TCGA provides:

> Subject to this section, every person
> [a] who at the time when the chargeable gain accrues to the company is

> resident or ordinarily resident in the UK, and
> [b] who is a participator in the company,
> shall be treated for the purposes of this Act as if a part of the chargeable gain had accrued to him.

The sidenote to s.13 calls this "attribution" of gains. Section 13(4)(9)(10) refers to gains "apportioned" to participators. The terms "attribute"/"apportion" are interchangeable.

39.2.1 *Computation of gains accruing to non-resident company*

The first step is to compute the chargeable gains accruing to the non-resident company. Section 13(11A) TCGA provides:

> For the purposes of this section the amount of the gain or loss accruing at any time to a company that is not resident in the UK shall be computed (where it is not the case) as if that company were within the charge to corporation tax on capital gains.

Indexation relief is applicable because a company within the charge to CT qualifies for that relief.

Section 80(1) FA 1996 provides:

> For the purposes of corporation tax all profits and gains arising to a company from its loan relationships shall be chargeable to tax as income ...

It is considered that gains on debts and other loan relationships (including life policies and foreign exchange gains) are not within s.13. Applying the deeming provision of s.13(11A) they are chargeable to tax as income, so no chargeable gain accrues on the disposal.[1]

For a participator who is an individual, this all seems to be too good to be true, which raises the question whether a court should construe the deeming provision purposively so as to avoid that result.[2] However, s.13 also applies to a participator which is a company. It would be anomalous if a corporate participator did *not* obtain indexation relief, and somewhat

1 Section 37 TCGA 1992.
2 As was done in *De Rothschild v Lawrenson* 67 TC 300.

surprising if loan relationship gains were treated as chargeable gains. The battle of the anomalies does not give a clear result, and the deeming provision should be given full effect.

Gains on debts or policies often qualify for other CGT reliefs, so the question whether such gains could fall within s.13 will not often arise.

39.2.2 *Identifying the participators*

The next step is to identify the participators in the non-resident company. Section 13(12) TCGA provides:

> In this section "participator", in relation to a company, has the meaning given by section 417(1) of the Taxes Act for the purposes of Part XI of that Act (close companies).

This takes us to the elaborate standard definition in s.417(1) ICTA; see 63.14 (Definition of "participator"). It was not drafted with s.13 in mind. One company can have too many participators for s.13 to cope with easily. I refer to this as the problem of "**overlapping participators**".

The problem may arise in the case of trusts,[3] loan creditors[4] and chains of companies.[5] The problem is solved in different ways in each case.

39.3 Overlapping participators: trusts

Suppose a company is owned by a trust. The trustees are participators. The beneficiaries, other than merely discretionary beneficiaries, are participators under s.417(1)[A] since they have an interest in the trust property. See 63.14.3 (Trustees and beneficiaries).

The difficulties this would cause for s.13 TCGA were recognised, and beneficiaries are taken out of s.13 by s.13(14) TCGA:

> For the purposes of this section, where—
> (a) the interest of any person in a company is wholly or partly represented by an interest which he has under any settlement ("his beneficial interest"), and

3 See 39.3 (Overlapping participators: trusts).
4 See 39.5 (Overlapping participators: loan creditors).
5 See 39.7 (Chains of non-resident companies).

(b) his beneficial interest is the factor, or one of the factors, by reference to which that person would be treated (apart from this subsection) as having an interest as a participator in that company,

the interest as a participator in that company which would be that person's shall be deemed, to the extent that it is represented by his beneficial interest, to be an interest of the trustees of the settlement (and not of that person), and references in this section, in relation to a company, to a participator shall be construed accordingly.

The CG Manual para 57252 correctly provides:

Beneficiaries
Where the trustees of a settlement, whether resident in the UK or not, are participators in a non-resident company then in certain circumstances a beneficiary of the settlement will also be within the definition of participator. The effect of Section 13(14) is that once you reach shares or other interests held by trustees, except in the case of a bare trust, see CG34300, you stop there. In deciding how the chargeable gain of the company should be apportioned, you treat the trustees as if they were the beneficial owners of their shares or other interests and apportion the gain to them as appropriate, ignoring the interests of the beneficiaries. If the trustees are resident then their share of the gain is assessed on them, [or on the settlor under TCGA 1992, S 77 in relevant cases].[6] If the trustees are non-resident then the gain is subject to TCGA 1992, S 86 and TCGA 1992, S 87, see CG57395. Any interest as a participator in the non-resident company which the beneficiary holds in their own right, for example by a personal holding of shares in the non-resident company, will remain within Section 13.

39.4 Amount of gain attributed to each participator

Once one has identified the participators, one asks how much of the company's gain is attributed to each of them. Section 13(3) TCGA provides:

That part shall be equal to the proportion of the gain that corresponds to the extent of the participator's interest as a participator in the company.

6 Words in square brackets are out of date since 2008.

This takes us to s.13(13) TCGA:

> In this section—
> (a) references to a person's interest as a participator in a company are references to the interest in the company which is represented by all the factors by reference to which he falls to be treated as such a participator.

That is, "interest" in s.13(3) is not construed in a narrow or technical manner. The section continues:

> (b) references to the extent of such an interest are references to the proportion of the interests as participators of all the participators in the company (including any who are not resident or ordinarily resident in the UK) which on a just and reasonable apportionment is represented by that interest.

What is just and reasonable? The CG Manual starts with general comments:

> **57261. Just and reasonable**
> It is quite possible for the application of the different factors by which persons are participators to produce different percentages for each of them. So under one test, for example entitlement to income, A may have 60% and B have 40% and under another test, for example entitlement to capital, A have 36%, B have 54% and C have 10%. This can happen even with relatively simple company structures, for example where there are preference shares, or loans. The total amount of gains apportioned cannot exceed the chargeable gain of the non-resident company. In this situation the gain has to be apportioned as is just and reasonable. This includes taking into account the interests of non-residents.
> **57262.**
> In considering a just and reasonable apportionment you should take into account all relevant factors, and not simply make an arithmetical adjustment. It would not usually be correct merely to average out the interests using the different factors. The aim of the provisions is to ensure that the gain is attributed to the participators who have the real economic interest in the non-resident company and who will derive the benefit of the gain however indirectly. The just and reasonable apportionment prevents an inappropriate part of the gain being attributed to persons without real economic interests, for example commercial loan

creditors, see CG57265.

39.5 Overlapping participators: loan creditors

The problem of overlapping participators including loan creditors is solved, or fudged, by a just and reasonable apportionment. The CG Manual provides:

> **57265. Loan creditors**
> Any loan creditor of the non-resident company is within the definition of participator as applied for the purposes of Section 13. As stated in CG57262 the aim of the provisions is to ensure that the gain is attributed to the participators who have the real economic interest in the non-resident company. There will be cases where a loan creditor will be a person or institution (such as a bank or similar financial institution) which has loaned money to the non-resident company as a matter of business on commercial terms. The interest of such a loan creditor acting at arms length will be limited to an expectation of repayment of the amount loaned together with payments of interest at a commercial rate. There will be no expectation that the loan creditor can or will benefit from the profits or gains of the non-resident company. In such a case it would not be just and reasonable to apportion any of the gain to a loan creditor of this type. The attribution should be made to those participators who have a real economic interest in the capital gains.
> **57266.**
> Where there are participators who are loan creditors it will be necessary to review all of the circumstances to satisfy yourself that the interests of the loan creditors can be excluded for the reasons in CG57265. In some cases the persons with the real economic interest in the non-resident company will be loan creditors whether or not they are participators under one or more of the other tests set out in CG57250. In such cases, where there is participation in more than one way, it may be appropriate, depending on the facts of the case, to aggregate their interests of those persons in reaching an apportionment that is just and reasonable.
> In other cases the persons with the real economic interest in the non-resident company may be providing the funds which the loan creditor has loaned to the company, and may be persons who are entitled to secure that income or assets (whether present or future) of the company will be applied directly or indirectly for their benefit, see CG57250 last bullet, and may be participators in their own right by virtue of that test.

39.6 CG Manual examples: shareholders v. loan creditors

39.6.1 *Non-resident shareholder*

The CG Manual starts with a very simple example:

57280. Computation of TCGA 1992, S 13 charge
Facts

- a non-resident company has issued share capital of 100 Ordinary shares
- A, B, C and D each own 25 shares
- A, B, C are all R/OR and domiciled in the UK. D is NR/NOR
- the non-resident company realises a gain of 200,000

CGT computations
You compute the TCGA 1992, S 13 charge as follows.
STEP 1
Calculate the gain that would have arisen if the non-resident company had been resident in the UK. This is 200,000.[7]
STEP 2
Determine the interests of all participators, including any who are not resident in the UK, by applying the tests of participation appropriate to the circumstances. In this case each of the four participators has a 25 per cent interest.
STEP 3
Calculate the proportion of the gain apportionable to the interests of each participator. Calculate the interests of all participators, including any who are not resident in the UK. In this case the proportion for each participator is 25% of 200,000 = 50,000
STEP 4
Consider whether the gains calculated in Step 3 represent a just and reasonable apportionment. In this case the apportionment is just and reasonable. Gains of 50,000 are attributed to each of A, B and C and treated as gains accruing to them on the date on which the gain actually accrued to the company.
D is not liable to UK taxation. But it would not be just and reasonable to reapportion D's gain of 50,000 to A, B and C as D has a real economic interest in the non-resident company.

39.6.2 *Examples with loan creditors*

The CG Manual then gives two examples involving loan creditors. The

7 Chargeable gains can accrue whether or not a company is UK resident. See 36.1 (Territorial scope of CGT), but the method of computation of the gain is different for a UK resident company. However this does not make any different to the examples.

first involves a loan on commercial terms:

> **57281. Computation of TCGA 1992, S 13 charge**
> Facts
> - A and B each own 50 shares
> - A and B are both R/OR and domiciled in the UK
> - C is a loan creditor for 400,000. The loan is an arm's length commercial transaction and interest is payable at a fully commercial rate on the loan
> - the non-resident company realises a gain of 500,000
> - the total capital of the non-resident company after the gain is 1,000,000

The solution is to disregard the loan creditor, though the Manual takes many lines to reach this conclusion:

> CGT computations
> You compute the TCGA 1992, S 13 charge as follows.
> STEP 1
> Calculate the gain that would have arisen if the non-resident company had been resident in the UK. This is 500,000.[8]
> STEP 2
> Determine the interests of all participators, including any who are not resident in the UK, by applying the tests of participation appropriate to the circumstances.
> A is a 50% participator by reference to the shareholding of 50 shares
> B is a 50% participator by reference to the shareholding of 50 shares
> C is a participator as a loan creditor, being entitled to an amount of 400,000 out of the total capital of 1,000,000
> STEP 3
> Calculate the proportion of the gain apportionable to the interests of each participator. In this case the proportion for each participator is
> A (as shareholder) 500,000 x 50% = 250,000
> B (as shareholder) 500,000 x 50% = 250,000
> C (as loan creditor) 500,000 x 40% = 200,000
> STEP 4
> Consider whether the gains calculated in Step 3 represent a just and reasonable apportionment. In this case the apportionment is not just and reasonable as the total of the gains under the initial apportionment exceeds the actual gain. C is a participator only by virtue of being a commercial loan creditor, see CG57265. C's entitlement as loan creditor should be ignored, subject to a review of the circumstances to establish that C is merely a commercial loan creditor and has no entitlement to a share of profits or gains, and that there are no other arrangements. In this example it is assumed that there are no other arrangements and therefore the whole of the gain should be apportioned by reference to the interests in shares. The final apportionment becomes

8 See above footnote.

A (as shareholder) 500,000 x 50% = 250,000
B (as shareholder) 500,000 x 50% = 250,000

The second example is the same but the loan is interest-free and from a shareholder:

57282. Computation of TCGA 1992, S 13 charge
Facts

- a non-resident company has issued share capital of 100 Ordinary shares
- A and B each own 50 shares
- A and B are both R/OR and domiciled in the UK
- A is a loan creditor for 200,000. No interest is payable on the loan
- the non-resident company realises a gain of 500,000.
- the total capital of the non-resident company after the gain is 1,000,000

The solution is *still* to disregard the loan creditor, though the Manual is not quite so confident in its answer:

CGT computations
You compute the TCGA 1992, S 13 charge as follows.
STEP 1
Calculate the gain that would have arisen if the non-resident company had been resident in the UK. This is 500,000.[9]
STEP 2
Determine the interests of all participators, including any who are not resident in the UK, by applying the tests of participation appropriate to the circumstances.
A is a 50% participator by reference to the shareholding of 50 shares
B is a 50% participator by reference to the shareholding of 50 shares
A is also a participator as a loan creditor, being entitled to an amount of 200,000 out of the total capital of 1,000,000. If all of the assets of the company were to be distributed immediately after the accrual of the gain the entitlements of A and B would be
A: 200,000 (as loan creditor) plus 50% of the balance of 800,000 (as shareholder), a total of 600,000 or 60% of the assets.
B: 400,000, 50% of the balance of 800,000 (as shareholder), or 40 % of the assets.
STEP 3
Calculate the proportion of the gain apportionable to the interests of each participator. In this case there are two possible apportionments.
A: 500,000 x 50% = 250,000
B: 500,000 x 50% = 250,000
or
A; 500,000 x 60% = 300,000

9 See above footnote.

B: 500,000 x 40% = 200,000
STEP 4
Consider whether the gains calculated in Step 3 represent a just and reasonable apportionment. As there are at least two possible apportionments we must consider all of the facts relating to the arrangements under which A's loan was made and the arrangements regarding profits and gains of the company.

- Does the loan agreement give A any preferential rights to profits or gains, or simply to a repayment of the capital?
- Is B entitled to an equal share of profits or gains?

In such cases there is no easy answer and a full consideration of all of the relevant circumstances is necessary. On the bare facts of this example A has no preferential rights and consequently an apportionment by reference to the shareholdings, effectively excluding A's participation as loan creditor, may be just and reasonable. If so, the gain would be attributed
A: 500,000 x 50% = 250,000
B: 500,000 x 50% = 250,000

39.6.3 *Two classes of shares*

The CG Manual's next example concerns a company with two classes of shares:

57283. Computation of TCGA 1992, S 13 charge
Facts

- a non-resident company has issued share capital of 100 A shares and 100 B shares.
- both classes of shares carry equal voting rights but the B shares carry no entitlement to dividends or distributions in a winding-up.
- the A shares are owned by X who is R/OR and domiciled in the UK
- the B shares are owned by Y who is NR/NOR
- the non-resident company realises a gain of 200,000.

CGT computations
You compute the TCGA 1992, S 13 charge as follows.
STEP 1
Calculate the gain that would have arisen if the non-resident company had been resident in the UK. This is 200,000.[10]
STEP 2
Determine the interests of all participators, including any who are not resident in the UK, by applying the tests of participation appropriate to the circumstances.
voting rights distributions
X 50% 100%
Y 50% 0%
X is a 50% participator by reference to voting rights attached to the shareholding

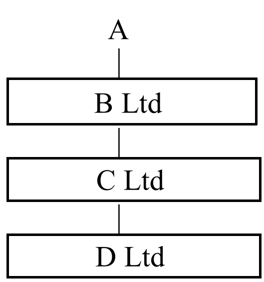
10 See above footnote.

in A shares.
Y is a 50% participator by reference to voting rights attached to the shareholding in B shares.
X is a 100% participator by reference to rights to dividends and distributions attached to the shareholding in A shares.
STEP 3
Calculate the proportion of the gain apportionable to the interests of each participator.
X (rights to income and capital) 200,000 x 100% = 200,000
Y (voting rights) 200,000 x 50% = 100,000
STEP 4
Consider whether the gains calculated in Step 3 represent a just and reasonable apportionment. In this case the apportionment is not just and reasonable as the total of the gains under the initial apportionment exceeds the actual gain. A full review of all of the circumstances would be necessary. It appears that the true economic interest in the non-resident company is held solely by X. Y's entitlement should be ignored, and the whole of the gain apportioned to X.

39.7 Chains of companies

39.7.1 *Overlapping participators: chains of wholly owned companies*

Suppose a chain of wholly owned companies:



C Ltd is a participator in D Ltd under s.417(1)[A] ICTA. But A and B Ltd are also participators, under s.419(1)[B](d) ICTA.[11] This is so wherever the companies are resident. Chains of wholly owned companies raise the problem of overlapping participators.

Section 13(9) TCGA provides:

[a] If a person who is a participator in the company at the time when the

11 See 63.14.1 (Chain of wholly owned companies).

chargeable gain accrues to the company is itself a company which

[i] is not resident in the UK but which

[ii] would be a close company if it were resident in the UK,

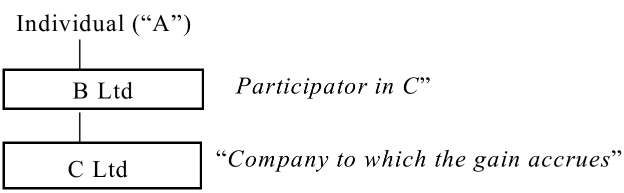
[b] [i] an amount equal to the amount apportioned under subsection (3) above out of the chargeable gain to the participating company's interest as a participator in the company to which the gain accrues

[ii] shall be further apportioned among the participators in the participating company according to the extent of their respective interests as participators, and

[c] subsection (2) above shall apply to them accordingly in relation to the amounts further apportioned,

[d] and so on through any number of companies.

Suppose a simple chain of two wholly owned non-resident companies:



If a gain accrues to C, what is apportioned to A? Under s.13(9)[b][i] it is "an amount equal to the amount apportioned under s.13(3)" to B as a participator in C. This is not well drafted, as nothing is apportioned under s.13(3) to B. No apportionment can be made since B is not UK resident![12] But the courts must correct that infelicity and construe the words to mean, the amount that would have been apportioned to B, had it been UK resident.

The CG Manual provides:

57290. Indirect interests

Without special rules UK resident shareholders or participators could avoid the TCGA 1992, S 13 charge by placing another non-resident company between themselves and the company making the gain. TCGA 1992, S 13(9) prevents this by allowing the Revenue to look through a chain of non-resident companies. The gain is apportioned to the first tier of UK residents or non-resident trusts in the chain of interests. For

12 One might also argue that apportionment is under s.13(2) and not s.13(3).

> TCGA 1992, S 13(9) to apply each company in the chain must itself satisfy the basic conditions outlined in CG57220.
> Therefore each company must be
> - a company that is not resident in the UK and
> - a company that would be a close company if it was resident in the UK.

The CG Manual begins with a straightforward example:

EXAMPLE 1[13]

Mr A	*UK resident and domiciled shareholder*
B Ltd	*non-resident close company*
C Ltd	*non-resident close company*
D Ltd	*non-resident close company*

Gains accruing to D Ltd are not attributed to C under s.13(2) because C is not UK resident. See s.13(2)[a]. But the CG Manual correctly notes:

> Any gains of D Ltd can be apportioned to Mr A because TCGA 1992, S 13(9) allows you to look through the chain of non-resident closely controlled companies.

The next example concerns a chain including a resident company:

EXAMPLE 2

Mr A	*UK resident and domiciled shareholder*
B Ltd	*UK resident company*
C Ltd	*non-resident close company*
D Ltd	*non-resident close company*

13 In the examples I have amended the format of the diagrams for the sake of clarity.

The Manual analyses this as follows:

> Any gains of D Ltd can be apportioned to B Ltd but not Mr A. This is because B Ltd is the first UK resident shareholder in the chain.

This was correct before 1995, when s.13(2) and (9) TCGA only apportioned gains to a *shareholder* in a non-resident company. A is not a shareholder of D Ltd. But why can't A be assessed now under s.13(2) or (9)? He *is* a participator in D Ltd. Perhaps this restricted rule is implied by s.13(9) TCGA. Or if not, perhaps it would be just and reasonable to apportion under 13(2) to company B and to no-one else. One way or the other, the problem of overlapping participators in chains of companies is solved by stopping at the first UK resident company.

The next two Manual examples are straightforward variations on the first two:

EXAMPLE 3

Mr A	*UK resident and domiciled shareholder*
B Ltd	*closely controlled*[14] *non-resident company*
C Ltd	*UK resident close company*
D Ltd	*non-resident close company*

> Any gains of D Ltd can be apportioned to C Ltd but not Mr A even though Mr A owns shares in B Ltd a closely controlled non-resident company.
>
> **57291. UK resident shareholder**
>
> When considering the operation of TCGA 1992, S 13(9) each chain of shareholdings must be considered separately.
>
> EXAMPLE

14 The express "closely controlled" is used here (somewhat unhelpfully) as a synonym of "close".

Mr A	*UK resident and domiciled shareholder*
B Ltd	*UK resident company*
C Ltd	*non-resident close company*
D Ltd	*non-resident close company*
Mrs B	*UK resident and domiciled shareholder*
E Ltd	*non-resident close company*

The gains of [E Ltd][15] can be apportioned to Mrs B because she is the first UK resident shareholder in that chain of shareholdings. The gains of D Ltd cannot be apportioned to Mr A because B Ltd is the first UK resident shareholder in that chain of shareholdings.

39.8 Chains of companies not wholly owned

We have so far considered simple chains of wholly owned companies. The CG manual continues with an example of a less than 100% chain:

57292. UK resident shareholder

You calculate the amount of a person's interest on a particular test, arising on an indirect interest, by multiplying the proportional interest in the assets of each company in the chain.

EXAMPLE

Mr A	*UK resident and domiciled shareholder*
75%	
B Ltd	*non-resident company*
75%	
C Ltd	*non-resident company*
50%	
D Ltd	*non-resident company*

The percentages show each shareholder's interest in the assets of the company in which it owns shares. If D Ltd makes gains of 100,000 the TCGA 1992, S 13 charge on Mr A is £100,000 x 50% x 75% x 75% = £28,125.

15 The original reads "D Ltd" which must be a slip for "E Ltd", if the diagram is correct.

Mr A is a participator in B Ltd. He is not a participator in D Ltd but that does not matter because C Ltd is a participator in D Ltd, B Ltd is a participator in C Ltd, and gains of D Ltd are attributed to Mr A under s.13(9) TCGA.

39.9 Section 13 remittance basis

Section 14A TCGA provides a relief which I call "**the s.13 remittance basis**". Section 14A(1) provides:

> This section applies if—
> (a) by virtue of section 13, part of a chargeable gain that accrues to a company on the disposal of an asset is treated as accruing to an individual in a tax year, and
> (b) the individual is not domiciled in the UK in that year.

In short, the relief applies to a remittance basis taxpayer. Section 14A(2) provides the relief:

> The part of the chargeable gain treated as accruing to the individual ("the deemed chargeable gain") is a foreign chargeable gain within the meaning of section 12 if (and only if) the asset is situated outside the UK.

I refer to those deemed chargeable gains as "**s.13 deemed gains**" to distinguish them from other deemed chargeable gains.

Section 14A(3) TCGA provides for the remittance basis:

> For the purposes of Chapter A1 of Part 14 of ITA 2007 (Remittance Basis)—
> (a) treat any consideration obtained by the company on the disposal of the asset as deriving from the deemed chargeable gain, and
> (b) unless the consideration so obtained is of an amount equal to the market value of the asset, treat the asset as deriving from the deemed chargeable gain.

In the absence of express provision, the s.13 deemed gain could not be remitted as it does not exist. Section 14A(3)(a) deals with that problem.

Section 14A(3)(b) is necessary since the equivalent rule in s.809T ITA only applies to gains accruing on a disposal by an individual.

Suppose:

(1) A non resident company ("OC") disposes of a foreign situate asset and realises a gain.
(2) The gain (or part) is deemed to accrue to F (an individual taxable under the remittance basis).

F is subject to tax on the gain if OC brings/receives/uses the sum in the UK, if a company is a relevant person in relation to F. A company within s.13 will be a relevant person.

If OC distributes the sum by way of dividend and F brings/receives/uses the sum in the UK then F is subject to two charges:

(1) CGT on the s.13 gain (for what he receives is derived from the gain) and
(2) IT on the distribution.

Company distribution relief may apply. The same applies if OC is held by an IP trust.

Likewise if OC is wound up and the liquidator distributes the sum by way of capital distribution, and F brings/receives/uses the sum in the UK then F is subject to two charges:

(1) CGT on the s.13 gain (for what he receives is derived from the gain) and
(2) CGT on the disposal of the shares in OC.

Company distribution relief may apply.

39.10 *De minimis* exemption

Section 13(4) TCGA provides a *de minimis* exemption:

> Subsection (2) above shall not apply in the case of any participator in the company to which the gain accrues where the aggregate amount falling *under that subsection* to be apportioned
> [a] to him and
> [b] to persons connected with him

does not exceed one tenth of the gain.

(Emphasis added)

39.10.1 *Aggregation of connected persons interests*

The first step for a participator is to identify all persons who are connected to him and who are also participators (i.e. connected co-participators).

In deciding whether a person ("A") satisfies the de minimis test, one does not look at the interest of all persons connected to A. One only looks at connected persons to whom gains are apportioned under s.13(2). One ignores persons connected with A if gains would not fall to be apportioned to them under that subsection. Assume a straightforward non-resident company:

(1) A owns 8% of the shares.
(2) C (the only participator connected with A) owns 3% of the shares.

A is within the scope of s.13 if C is a UK resident individual. But if C is a non-resident individual, gains cannot be apportioned to C, under s.13(2), so A qualifies for the *de minimis* exemption.

Often it will not be possible for A to know the position, but he must do the best he can.

If C is a non-resident *trust*, are gains attributable to B under s.13(2)? Section 13(10) says that gains are attributable to the trustees "under this section". Not under subsection (2). So the answer is, no. If the question arose in a tax avoidance context a court would be tempted to construe the section non-literally. But there may be many connected co-participators and A may not be able to know whether they are trustees or not, so it is sensible to disregard the interests of non-resident trustees for the purposes of the aggregation test.

If C is a non-resident *company*, the gains may be apportioned to participators, C, but that does not matter unless those participators are themselves connected to C.

39.11 Non-resident trading companies

Section 13(5) TCGA provides:

> This section shall not apply in relation to ...
> (b) a chargeable gain accruing on the disposal of an asset used, and used only—
> (i) for the purposes of a trade carried on by the company wholly outside the UK, or
> (ii) for the purposes of the part carried on outside the UK of a trade carried on by the company partly within and partly outside the UK,
> (c) a chargeable gain accruing on the disposal of currency or of a debt within section 252(1), where the currency or debt is or represents money in use for the purposes of a trade carried on by the company wholly outside the UK...

I cannot see the point of s.13(5)(c) which duplicates s.13(5)(b)(I) but it does not matter.

Gains on debts are in any case outside the scope of s.13 because of the loan relationship rules.

39.12 Non-resident company within CT

Section 13(5) TCGA provides:

> This section shall not apply in relation to ...
> (d) to a chargeable gain in respect of which the company is chargeable to tax by virtue of section 10B.[16]

39.13 Non-resident trustees

Non-resident trustees would not be within s.13(2) TCGA because that only applies to UK residents. However, s.13(10) TCGA provides:

> The persons treated by this section as if a part of a chargeable gain accruing to a company had accrued to them shall include the trustees of a settlement who are participators
> [a] in the company, or
> [b] in any company amongst the participators in which the gain is apportioned under subsection (9) above,
> if when the gain accrues to the company the trustees are neither resident

16 See 64.1 (Why does permanent establishment matter?).

nor ordinarily resident in the UK.

39.14 Pension schemes

Pension schemes qualify for CGT relief under s.271(1)(c) and (1A) TCGA:

> (1) The following gains shall not be chargeable gains—
> ...
> (c) any gain accruing to a person from his acquisition and disposal of assets held by him as part of a fund—
> (i) mentioned in section 614(2) of the Taxes Act,
> (ii) to which section 615(3) of the Taxes Act applies, or
> (iii) mentioned in section 648, 649, 650, 651 or 653 of ITEPA 2003;
> ...
> (1A) A gain accruing to a person on a disposal of investments held for the purposes of a registered pension scheme is not a chargeable gain.

This does not include relief from s.13 deemed gains but s.13(10B) TCGA provides relief:

> A chargeable gain that would be treated as accruing to a person under subsection (2) above shall not be so treated if—
> (a) it would be so treated only if assets that are assets of a pension scheme[17] were taken into account in ascertaining that person's interest as a participator in the company, and
> (b) at the time the gain accrues a gain arising on a disposal of those assets would be exempt from tax by virtue of section 271(1)(c) or (1A).

A beneficiary of a pension scheme might be a participator in a non-resident company held by the scheme, but he is protected by the exclusion for beneficiaries.[18] Section 13(10B) is not needed to prevent aggregation of the pension scheme's interest for the purposes of the 10% *de minimis*

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17 This expression is defined in s.13(10B):
"In para (a) above 'assets of a pension scheme' means assets held for the purposes of a fund or scheme to which any of the provisions mentioned in para (b) above applies."

18 See 39.3 (Overlapping participators: trusts).

test as a beneficiary is not connected with his pension scheme.

39.15 Partnership holding non-resident company

Suppose a partnership holds a non-resident company to which a gain accrues. Section 59(1) TCGA provides:

> Where 2 or more persons carry on a trade or business in partnership—
> (a) tax in respect of chargeable gains accruing to them on the disposal of any partnership assets shall, in Scotland as well as elsewhere in the UK, be assessed and charged on them separately, and
> (b) any partnership dealings shall be treated as dealings by the partners and not by the firm as such.

This does not apply to a s.13 gain, which is not a gain on the disposal of a partnership asset. But the partners are participators in the company, and it is just and reasonable (because it fits the scheme of the TCGA) to attribute the s.13 gain to the partners under s.13(2) TCGA. That is, HMRC do not need s.59 TCGA to tax the partners.

39.16 Company distribution relief

Section 13 could often give rise to double taxation and there are two reliefs to prevent this. Statute does not provide names for the reliefs, so I coin the following terminology:

Name of relief	**TCGA section**	**Outline of relief**
Company distribution relief	s.13(5A)	Relief on distribution by non-resident company
Company disposal relief	s.13(7)	Relief on disposal of interest in resident company

Section 13(5A) TCGA provides:

> Where—
> (a) an amount of tax is paid by a person in pursuance of subsection (2) above, and
> (b) an amount in respect of the chargeable gain is distributed (either by

way of dividend or distribution of capital or on the dissolution of the company) before the end of the period specified in subsection (5B) below,

the amount of tax (so far as neither reimbursed by the company nor applied as a deduction under subsection (7) below) shall be applied for reducing or extinguishing any liability of that person to income tax, CGT or corporation tax in respect of the distribution.

In short, the s.13 tax is set against tax on the distribution.

The CG Manual provides a worked example:

57365. Distribution to participators

This example illustrates the operation of TCGA 1992, s 13 (5A) if the company realises a gain on or after 28 November 1995 and distributes an amount in respect of the gain to participators.

Facts

- A UK resident and domiciled shareholder owns half the shares in a non-resident close company. The company structure is straightforward and the UK resident is a 50% participator.
- In January 1996 the non-resident company sells an asset realising a gain of £100,000.
- The UK resident has no other gains in 1995-96 but is chargeable to CGT at 40%.
- In June 1996 the company makes a distribution of £100,000 to its shareholders. The UK resident is chargeable at 40% on the amount received.[19]

Capital Gains Tax treatment

January 1996 - The ordinary rules of TCGA 1992, s 13 apply. Half the gain of £100,000 is attributable to the shareholder and is chargeable to CGT in 1995-96. The tax due is

	Section 13 gain	£50,000
less	annual exemption	£ 6,000
		£44,000
	CGT @ 40 %	£17,600

June 1996 - *As an amount in respect of the whole of the gain has been distributed*, the whole of the tax paid is available for set off. The Income Tax due on the distribution for 1996-97 is

	Distribution	£50,000
	IT @ 40%	£20,000
less	Section 13 tax	£17,600
	Tax due	£ 2,400

19 This was the rate of income tax on foreign company distributions in 1996.

39.16.1 *Time limit for distribution*

Section 13(5B) TCGA sets out the time limit for company distribution relief:

> The period referred to in subsection (5A)(b) above is the period of three years from—
> (a) the end of the period of account of the company in which the chargeable gain accrued, or
> (b) the end of the period of twelve months beginning with the date on which the chargeable gain accrued,
> whichever is earlier.

39.16.2 *Remittance basis taxpayer*

The relief applies even to foreign s.13 deemed gains which are taxed on a remittance basis, but the relief only sets tax on the s.13 deemed gain against tax on the distribution, so the relief does not apply unless the s.13 deemed gain is remitted (so tax is paid on it), and the distribution is remitted (so tax otherwise paid on the distribution qualifies for relief. Thus suppose:

(1) Year 1: A company realises a gain deemed to accrue to a remittance basis taxpayer under s.13 but not taxed as there is no remittance.
(2) Year 3: The company declares a dividend in respect of the gain. The dividend is RFI but not taxable as there is no remittance.
(3) Year 10: the gain and the dividend are remitted.

The relief applies. The time limit is met as the distribution was within 3 years of the relevant time, the time that the gain accrued to the company. The date of the remittance is not relevant.

39.17 Company disposal relief

Section 13(7) TCGA provides:

> The amount of CGT paid by a person in pursuance of subsection (2) above (so far as neither reimbursed by the company nor applied under subsection (5A) above for reducing any liability to tax) shall be allowable as a deduction in the computation under this Act of a gain accruing on the disposal by him of any asset representing his interest as

a participator in the company.

This sets tax against the gain, so it is not generous. The CG Manual provides:

> **57370 Disposal of interest by UK resident** [November 2008]
> A UK resident who has incurred a charge under s.13 TCGA 1992 may later dispose of the shares or other interest in the non-resident company. Any tax paid by the UK resident in respect of the s.13 TCGA 1992 charge should be allowed as a deduction in computing the gain on the disposal of the shares or other interest. No deduction is due if the tax was paid by the non-resident company, see CG57390. Indexation allowance is not given on the tax paid. Although the tax is allowed as a deduction in computing the gain it is not expenditure within s.38(1)(a) TCGA 1992 or s.38(1)(b) TCGA 1992. Therefore it is not relevant allowable expenditure for indexation allowance purposes, see CG17240.
> NOTE. Indexation allowance for taxpayers within the charge to CGT has been frozen at April 1998, see CG17207. For details of the replacement provision, taper relief, see CG17895+.
> **CG57371 - NR companies: disposal of interest/shares by UK resident**
> This example illustrates the deduction under TCGA92/S13(7) if the taxpayer sells shares in a non-resident company whose gains have been apportioned under TCGA92/S13.
> **Facts**
> - June 2008 a taxpayer buys 500 out of the 750 issued shares in X Ltd, a non-resident close company, at a cost of £100,000.
> - March 2009 X Ltd realises a gain of £6,000. 500/750 x £6,000 = £4,000 is apportioned to the taxpayer. The amount is included in the 2008-09 Capital Gains Tax assessment. The taxpayer is liable at 18% and tax of £720 is due.
> - August 2010 the taxpayer sells the shares for £130,000.
>
> **Chargeable Gain**

			£
	Disposal proceeds		130,000
less	Cost	100,000	
less	Section 13(7) deduction	720	100,720
	Chargeable gain		**29,280**
less	Annual exempt amount (say)		10,200
Amount chargeable			19,080

> NOTE. If a taxpayer is within the charge to Capital Gains Tax, neither indexation allowance nor taper relief apply to disposals of assets on or after 6 April 2008. Previously indexation allowance had been frozen at April 1998. For indexation allowance see CG17207+ and for taper relief see CG17895+.

Section 14A(5) TCGA provides:

> Section 13(7) (deduction on disposal of interest in company) does not apply to the extent that the amount of tax mentioned there is attributable to the deemed chargeable gain.

The relief is disallowed even if the s.13 deemed gain (which statute calls the deemed chargeable gain) is remitted and so taxable. It is difficult to see any good reason for this discrimination against foreign domiciliaries, except perhaps a policy to make the remittance basis claim less attractive.

39.18 Order of reliefs

Section 13(7A) TCGA provides:

> In ascertaining for the purposes of subsection (5A) or (7) above the amount of CGT or income tax chargeable on any person for any year on or in respect of any chargeable gain or distribution—
> (a) any such distribution as is mentioned in subsection (5A)(b) above and falls to be treated as income of that person for that year shall be regarded as forming the highest part of the income on which he is chargeable to tax for the year;
> (b) any gain accruing in that year on the disposal by that person of any asset representing his interest as a participator in the company shall be regarded as forming the highest part of the gains on which he is chargeable to tax for that year;
> (c) where any such distribution as is mentioned in subsection (5A)(b) above falls to be treated as a disposal on which a gain accrues on which that person is so chargeable, that gain shall be regarded as forming the next highest part of the gains on which he is so chargeable, after any gains falling within para (b) above; and
> (d) any gain treated as accruing to that person in that year by virtue of subsection (2) above shall be regarded as the next highest part of the gains on which he is so chargeable, after any gains falling within para (c) above.

The CG Manual provides:

> **57375. Tax relief ordering rules**
> Where the events which can give rise to relief under Section 13(5A) and (7) occur within a single tax year, there can, in certain circumstances, be computational problems. To prevent this subsection (7A) sets out the order of priority to be given to each tax charge. In ascertaining for the

purposes of subsections (5A) and (7) the amount of CGT or IT which is chargeable on a person for a year, the order is
a) any distribution which is chargeable as income is treated as the top slice of income for that year
b) any gain accruing on the disposal of any asset representing the participator's interest in the non-resident company is treated as the top slice of gains for that year
c) any gain accruing on a capital distribution is treated as the second slice of gains for that year
d) the gain attributed to the participator under Section 13 is treated as the third slice of gains for that year.

39.19 Loss accruing to non-resident company

39.19.1 *UK domiciled participator*

Section 13(8) TCGA provides:

> [a] So far as it would go to reduce or extinguish chargeable gains accruing by virtue of this section to a person in a year of assessment this section shall apply in relation to a loss accruing to the company on the disposal of an asset in that year of assessment as it would apply if a gain instead of a loss had accrued to the company on the disposal, but shall only so apply in relation to that person;
> [b] and subject to the preceding provisions of this subsection this section shall not apply in relation to a loss accruing to the company.

The CG Manual correctly provides:

> **57295. General**
> TCGA 1992, S 13 is concerned with the apportionment of gains not losses. If the disposal by the non-resident company gives rise to a loss that loss cannot be apportioned to UK residents for them to set it off against their other gains. However, the loss can be set-off
> - against gains made by the same company in the same year of assessment. See CG57296.
> - against gains made by other non-resident companies which have been apportioned to the taxpayer in the same year of assessment. See CG57297.
>
> **57296. Same company**
> If the non-resident company makes gains and losses in the same year of

assessment the losses can be set off against the gains. Any surplus losses cannot be carried forward or back to set-off against gains arising in a different year of assessment.

57297. Different companies

If the UK resident owns shares or is a participator in more than one non-resident company the proportion of the gains and losses of those companies apportioned to the UK resident can be set off against each other in the same year of assessment. Any surplus loss cannot be carried forward or back to set against the gains arising in different years of assessment.

57298. Years of assessment

Year of assessment in CG57295-CG57297 means the year of assessment for the UK resident. Where the participator is a UK resident company the references to years of assessment in CG57295-CG57297 are references to accounting periods of the participator.

39.19.2 *Remittance basis taxpayer*

Section 14A(4) TCGA 1992 provides:

> If—
> (a) the deemed chargeable gain is a foreign chargeable gain (within the meaning of section 12),
> (b) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for the year mentioned in subsection (1), and
> (c) any of the deemed chargeable gain is remitted to the UK in a tax year after that year,
> the chargeable gain treated under section 12(2) as accruing may not be reduced or extinguished under section 13(8).

Careful planning is needed to ensure that loss relief is available.

39.20 Individual's CGT paid by non-resident company

Tax on the s.13 gain is due from the individual and not from the company. The individual has no statutory right of indemnity against the company. But it is possible that the company might pay the tax on the s.13 gain voluntarily, or perhaps a participator might protect himself by entering into a contract requiring the company to pay the tax.

Section 13(11) TCGA provides:

> If any tax payable by any person by virtue of subsection (2) above is paid
> [a] by the company to which the chargeable gain accrues,
> [b] or in a case under subsection (9) above is paid by any such other company,
> the amount so paid shall not for the purposes of income tax, CGT or corporation tax be regarded as a payment to the person by whom the tax was originally payable.

The CG Manual provides a précis:

> **57390. Payment of UK tax by NR company**
> The non-resident company may pay the UK tax due from a UK resident when gains have been apportioned to him under TCGA 1992, S 13. If so, TCGA 1992, S 13 (11) provides that the payment of the tax on behalf of the UK resident does not give rise to any further liability in the hands of the UK resident. You do not treat the payment as income of the resident or as a capital distribution in respect of the shares in the non-resident company. TCGA 1992, S 13 (11) will also apply if the liability arises because a UK resident has an indirect shareholding in the non-resident company. The liability can be paid by any of the non-resident close companies in the chain.

In practice a distribution in respect of the gain is the best course.

39.21 Non-resident group relief

A full discussion of group relief requires a book to itself. The discussion here must be somewhat curtailed.

39.21.1 *Meaning of "non-resident group"*

Section 14(4) TCGA provides:

> For the purposes of this section—
> (a) a "non-resident group" of companies—
> (i) in the case of a group, none of the members of which are resident in the UK, means that group, and
> (ii) in the case of a group, 2 or more members of which are not resident in the UK, means the members which are not resident

in the UK;

(b) "group" shall be construed in accordance with section 170.

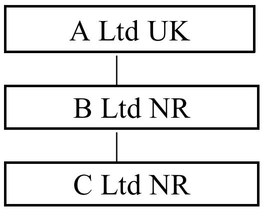
In outline, the definition of group is in s.170(3) TCGA:

> Subject to subsections (4) to (6) below—
>
> (a) a company (referred to below and in sections 171 to 181 as the "principal company of the group") and all its 75 per cent subsidiaries form a group and, if any of those subsidiaries have 75 per cent subsidiaries, the group includes them and their 75 per cent subsidiaries, and so on, but
>
> (b) a group does not include any company (other than the principal company of the group) that is not an effective 51 per cent subsidiary of the principal company of the group.

The CG Manual provides:

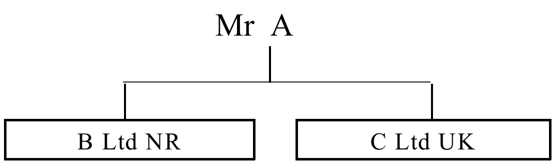
> **57401. NR group**
>
> For the purposes of TCGA 1992, S 13 TCGA 1992, S 14(4)(b) amends the definition of group in TCGA 1992, S 170 by omitting the references to companies resident in the UK and particular types of company. It then defines a non-resident group as being either
>
> - two or more members of the same group, using the amended definition, both of which are non-resident. A UK resident company cannot be a member of the non-resident group. A non-resident company cannot be a member of the UK group. But a UK resident company can group two non-resident companies, see Example 1
>
> or
>
> - the whole of the group if none of the members are resident in the UK.
>
> FA 2000, Sch 29, Para 1 amended TCGA 1992, S 170 to remove the requirement that members of a group had to be resident in the UK. For the purposes of TCGA 1992, S 14, the definition of a non-resident group remains unchanged by this amendment.
>
> EXAMPLE 1[20]

20 I have amended the diagrams to increase clarity.



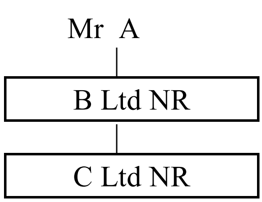
B Ltd and C Ltd form a non-resident group.
A Ltd is not a member of the non-resident group but it does have the effect of overseas "grouping" B Ltd and C Ltd.

EXAMPLE 2



B Ltd and C Ltd do not form a non-resident group because they are not members of any group.

EXAMPLE 3



B Ltd and C Ltd form a non-resident group because all of the companies in the group are not resident.

39.21.2 *Group relief*

Section 14 TCGA provides:

Non-resident groups of companies
(1) This section has effect for the purposes of section 13.
(2) The following provisions—
(a) section 41(8),
(b) section 171 (except subsections (1)(b) and (1A)),
(c) section 173 (with the omission of the words "to which this section

applies" in subsections (1)(a) and (2)(a) and "such" in subsections (1)(c) and (2)(c) and with the omission of subsection (3)),

(d) section 174(4) (with the substitution of "at a time when both were members of the group" for "in a transfer to which section 171(1) applied"), and

(e) section 175(1) (with the omission of the words "to which this section applies"),

shall apply in relation to non-resident companies which are members of a non-resident group of companies as they apply in relation to companies which are members of a group of companies.

This incorporates group relief for UK groups by reference.

Section 171(1) TCGA confers the relief. Amended as s.14 TCGA directs, this provides:

> Where—
>
> (a) a company ("company A") disposes of an asset to another company ("company B") at a time when both companies are members of the same group,
>
> company A and company B are treated for the purposes of corporation tax on chargeable gains as if the asset were acquired by company B for a consideration of such amount as would secure that neither a gain nor a loss would accrue to company A on the disposal.

Section 171 goes on to set out 11 exceptions where the relief does not apply, these are not discussed here.

The CG Manual provides:

> **57404. Section 14 – UK resident** [April 2007]
>
> As shown in Example 3 in CG57401 Section 14 TCGA 1992 applies even if the UK resident shareholder[21] is not a company. Some taxpayers and tax advisers are uncertain about this because Section 171 TCGA 1992 includes the words 'so far as relates to Corporation Tax on chargeable gains'.[22] They suggest this means Section 14 can only apply if the Section 13 TCGA 1992 charge would be to Corporation Tax on

21 This should read: "participator".

22 The Manual is a decade out of date, because since 2000 the wording is "for the purposes of corporation tax on chargeable gains" but the revised wording does not alter the position.

> chargeable gains. We do not take this restrictive view. This practice was published in Tax Bulletin, Issue 7, page 74.[23]

This is a somewhat cavalier view. Normally it will favour the taxpayer and so will not be challenged. But there are cases where it will be in the taxpayer's interest to argue that group relief does not apply.

39.21.3 *Clawback charge*

Section 14(3) TCGA provides:

> Section 179 (except subsections (1)(b) and (1A)) shall apply for the purposes of section 13 as if for any reference therein to a group of companies there were substituted a reference to a non-resident group of companies, and as if references to companies were references to companies not resident in the UK.

This incorporates the clawback rules for groups by reference. Amended as s.14(3) directs, s.179 TCGA in outline provides:

> (1) This section applies where—

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23 Now classified as RI 43 which provides:

"**Non-resident companies: attribution of gains to UK shareholders: 'non-resident groups': TCGA 1992 ss13, 14, 171–174, 175(1), 178–180**

In some circumstances gains realised by non-resident companies may be attributed to shareholders who are resident or ordinarily resident in the UK. The main provisions are in TCGA 1992 s 13. The scope of the legislation is not quite as wide ranging as it may seem because some of the group provisions which apply to UK groups for the taxation of gains—for example those relating to intra-group transfers—are imported for s 13 purposes from elsewhere in TCGA 1992 (see s 14). An intra-group transfer by members of a 'non-resident group' would thus be treated as taking place at no gain and no loss so there would be no gain on the disposal to attribute to UK shareholders.

In relation to the application of the no gain/no loss rule in these circumstances [the Revenue] have been asked whether the words 'so far as relates to corporation tax on chargeable gains' in TCGA 1992 s 171 limit its application to situations where the gain on the intra-group transaction would otherwise be within the charge to corporation tax.

In [the Revenue's] view the no gain/no loss rule is not limited in this way. The benefit of the rule is given whether the shareholder is assessable to CGT or to corporation tax. A similar view is also taken when considering the operation of any of the other sections referred to in TCGA 1992 s 14."

(a) a company not resident in the UK ("company A") acquires an asset from another company not resident in the UK ("company B") at a time when company B is a member of a non-resident group,

...

(c) company A ceases to be a member of that non-resident group within the period of six years after the time of the acquisition.

References in this section to a company not resident in the UK ceasing to be a member of a non-resident group of companies not resident in the UK do not apply to cases where a company not resident in the UK ceases to be a member of a non-resident group in consequence of another member of the non-resident group ceasing to exist.

...

(2) Where 2 or more associated companies not resident in the UK cease to be members of the non-resident group at the same time, subsection (1) above shall not have effect as respects an acquisition by one from another of those associated companies not resident in the UK.

(2A) Where—

(a) a company not resident in the UK ("company A") that has ceased to be a member of a non-resident group of companies not resident in the UK ("the first non-resident group") acquired an asset from another company not resident in the UK ("company B") which was a member of that non-resident group at the time of the acquisition,

(b) subsection (2) above applies in the case of company A's ceasing to be a member of the first non-resident group so that subsection (1) above does not have effect as respects the acquisition of that asset,

(c) company A subsequently ceases to be a member of another non-resident group of companies not resident in the UK ("the second non-resident group"), and

(d) there is a connection between the two non-resident groups,

subsection (1) above shall have effect in relation to company A's ceasing to be a member of the second non-resident group as if it had been the second non-resident group of which both companies not resident in the UK had been members at the time of the acquisition.

(2B) For the purposes of subsection (2A) above there is a connection between the first non-resident group and the second non-resident group if, at the time when company A ceases to be a member of the second non-resident group, the company not resident in the UK which is the principal company of that non-resident group is under the control of—

(a) the company not resident in the UK which is the principal company of the first non-resident group or, if that non-resident group no longer exists, which was the principal company of that non-resident group when company A ceased to be a member of it;

(b) any person or persons who control the company not resident in the UK mentioned in para (a) above or who have had it under their control at any time in the period since company A ceased to be a member of the first non-resident group; or

(c) any person or persons who have, at any time in that period, had under their3 control either—

(i) a company not resident in the UK which would have been a person falling within para (b) above if it had continued to exist, or

(ii) a company not resident in the UK which would have been a person falling within this paragraph (whether by reference to a company not resident in the UK which would have been a person falling within that paragraph or to a company not resident in the UK or series of companies not resident in the UK falling within this subparagraph).

(2C) This section shall not have effect as respects any asset if, before the time when company A ceases to be a member of the non-resident group or, as the case may be, the second non-resident group, an event has already occurred by virtue of which the company not resident in the UK falls by virtue of section 101A(3) to be treated as having sold and immediately reacquired the asset at the time specified in subsection (3) below.

(2D) This section shall not have effect as respects any asset if, before the time when company A ceases to be a member of the non-resident group or, as the case may be, the second non-resident group, an event has already occurred by virtue of which the company not resident in the UK falls by virtue of section 101C(3) to be treated as having sold and immediately reacquired the asset at the time specified in subsection (3) below.

(3) If, when company A ceases to be a member of the non-resident group, company A, or an associated company not resident in the UK also leaving the non-resident group, owns, otherwise than as trading stock—

(a) the asset, or

(b) property to which a chargeable gain has been carried forward from the asset on a replacement of business assets,

then, subject to subsection (4) below, company not resident in the UK A shall be treated for all the purposes of this Act as if immediately after its acquisition of the asset it had sold, and immediately reacquired, the asset at market value at that time.

(4) Any chargeable gain or allowable loss accruing to company A on the sale referred to in subsection (3) above shall be treated as accruing to company A at whichever is the later of the following, that is to say—

(a) the time immediately after the beginning of the accounting period of that company not resident in the UK in which or, as the case may be, at the end of which the company not resident in the UK ceases to be a member of the non-resident group; and

(b) the time when under subsection (3) above it is treated as having reacquired the asset;

and sections 403A and 403B of the Taxes Act (limits on non-resident group relief) shall have effect accordingly as if the actual circumstances were as they were treated as having been.

(5) Where, apart from subsection (6) below, a company not resident in the UK ceasing to be a member of a non-resident group by reason only of the fact that the principal company of the non-resident group becomes a member of another non-resident group would be treated by virtue of subsection (3) above as selling an asset at any time, subsections (6) to (8) below shall apply.

(6) The company in question shall not be treated as selling the asset at that time; but if—

(a) within 6 years of that time the company in question ceases at any time ("the relevant time") to satisfy the following conditions, and
(b) at the relevant time, the company in question, or a company not resident in the UK in the same non-resident group as that company, owns otherwise than as trading stock the asset or property to which a chargeable gain has been carried forward from the asset on a replacement of business assets,

the company in question shall be treated for all the purposes of this Act as if, immediately after its acquisition of the asset, it had sold and immediately reacquired the asset at the value that, at the time of acquisition, was its market value.

(7) Those conditions are—

(a) that the company not resident in the UK is a 75 per cent subsidiary of one or more members of the other non-resident group referred to in subsection (5) above, and
(b) that the company not resident in the UK is an effective 51 per cent subsidiary of one or more of those members.

(8) Any chargeable gain or allowable loss accruing to the company not resident in the UK on that sale shall be treated as accruing at the relevant time.

(9) Where—

(a) by virtue of this section a company not resident in the UK is treated as having sold an asset at any time, and
(b) if at that time the company not resident in the UK had in fact sold the asset at market value at that time, then, by virtue of section 30, any allowable loss or chargeable gain accruing on the disposal would have been calculated as if the consideration for the disposal were increased by an amount,

subsections (3) and (6) above shall have effect as if the market value at that time had been that amount greater.

(9A) Section 416(2) to (6) of the Taxes Act (meaning of control) shall have effect for the purposes of subsection (2B) above as it has effect for the purposes of Part XI of that Act; but a person carrying on a business of banking shall not for the purposes of that subsection be regarded as having control of any company not resident in the UK by reason only of having, or of the consequences of having exercised, any rights of that person in respect of loan capital or debt issued or incurred by the company not resident in the UK for money lent by that person to the company not resident in the UK in the ordinary course of that business.

(10) For the purposes of this section—

(a) 2 or more companies not resident in the UK are associated companies not resident in the UK if, by themselves, they would form a non-resident group of companies not resident in the UK,
(b) a chargeable gain is carried forward from an asset to other property on a replacement of business assets if, by one or more claims under sections 152 to 158, the chargeable gain accruing on a disposal of the asset is reduced, and as a result an amount falls to be deducted from the expenditure allowable in computing a gain accruing on the disposal of the other property,

(c) an asset acquired by company A shall be treated as the same as an asset owned at a later time by that company not resident in the UK or an associated company not resident in the UK if the value of the second asset is derived in whole or in part from the first asset, and in particular where the second asset is a freehold, and the first asset was a leasehold and the lessee has acquired the reversion.

(13) Where under this section company A is to be treated as having disposed of, and reacquired, an asset, all such recomputations of legibility in respect of other disposals, and all such adjustments of tax, whether by way of assessment or by way of discharge or repayment of tax, as may be required in consequence of the provisions of this section shall be carried out.

39.22 Private residence relief

Suppose T owns a non-resident company, which holds a house that is T's main residence. If the company disposes of the house, and a gain accrues to T, does private residence relief apply? Section 222(1) TCGA provides:

> This section applies to a gain accruing to an individual so far as attributable to the disposal of, or of an interest in—
> (a) a dwelling-house or part of a dwelling-house which is, or has at any time in *his* period of ownership been, his only or main residence, or
> (b) land *which he has* for his own occupation and enjoyment with that residence as its garden or grounds up to the permitted area.
>
> (emphasis added)

The gain does accrue to an individual, and it is attributable to the disposal of the dwellinghouse. However, no relief applies because:

(1) the condition in (b) is not met: there is no land which T *has*;
(2) the condition in (a) is not met: the company's period of ownership is not *his* period of ownership.

T might argue that the section should read non-literally, but it is not absurd to deny private residence relief when a house is held through a company. The policy is consistent with s.13(11A) TCGA which computes gains as if the company were within the charge to CT, and no-one suggests a UK resident company qualifies for private residence relief.

Likewise if the company is held by a trust, no relief applies to the trustees and the gain on the disposal is a s.2(2) amount or a s.86 amount.

39.23 Administration and appeals

The CG Manual provides:

> **57270. Liaison: other offices**
> As you are required to make an apportionment that is just and reasonable by reference to the interests of all of the participators, you will need to liaise with other officers dealing with participators in the non-resident company. In appropriate cases you should agree that a single nominated officer co-ordinate the progress of the enquiries, or conduct the enquiry in respect of some or all of the participators, for example, where all of the participators are represented by the same agent. In any case where a non-resident trust is involved, FICO, see CG57395, should be notified and will normally act as the office co-ordinating the Revenue's enquiries.
> **57271. NR companies: gains accruing after 28/11/95: charge under TCGA92 S13**:
> ... It will usually be appropriate to ensure that all appeals relating to the extent of the interests of participators with regard to a particular gain are heard at the same hearing, see IM4925.

CHAPTER FORTY

CAPITAL LOSSES

40.1 Deduction of losses

Section 2(2) TCGA provides for the deduction of losses:

> Capital gains tax shall be charged on the total amount of chargeable gains accruing to the person chargeable in the year of assessment, after deducting—
> (a) any allowable losses accruing to that person in that year of assessment, and
> (b) so far as they have not been allowed as a deduction from chargeable gains accruing in any previous year of assessment, any allowable losses accruing to that person in any previous year of assessment (not earlier than the year 1965–66).

Section 2 refers to a "person", so it applies to individuals, trustees, companies and PRs.

Section 2(2)(a) deducts current year losses and s.2(2)(b) deducts brought forward losses. Section 2(3) TCGA disallows carry-back of losses (unnecessarily) and provides two commonsense restrictions on loss relief:

> [a] Except as provided by section 62,[1] an allowable loss accruing in a year of assessment shall not be allowable as a deduction from chargeable gains accruing in any earlier year of assessment, and
> [b] relief shall not be given under this Act more than once in respect of any loss or part of a loss, and
> [c] shall not be given under this Act if and so far as relief has been or may be given in respect of it under the Income Tax Acts.

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1 See 37.4 (Carry-back of losses on death).

In this chapter:

"**Personal losses**" means losses accruing to individuals.
"**Trust losses**" means losses accruing to trustees.

For offshore fund losses, see 23.26 (Losses). For losses in the year of arrival and departure from the UK, see 6.18.1 (Losses). For losses of temporary non-residents see 8.5 (Gains and losses of intervening years). For interaction of loss relief and foreign tax credits, see 41.3.4 (HMRC practice: quantum of relief).

40.2 Allowable loss

Section 2 TCGA refers to "allowable" losses. This is a label which brings in a large number of rules; for whenever the drafter wishes to disallow a loss he directs that it is not allowable. The starting point is s.16 TCGA which provides:

> (1) Subject to sections 261B, 261D and 263ZA and except as otherwise expressly provided the amount of a loss accruing on a disposal of an asset shall be computed in the same way as the amount of a gain accruing on a disposal is computed.
> (2) Except as otherwise expressly provided, all the provisions of this Act which distinguish gains which are chargeable gains from those which are not, or which make part of a gain a chargeable gain, and part not, shall apply also to distinguish losses which are allowable losses from those which are not, and to make part of a loss an allowable loss, and part not; and references in this Act to an allowable loss shall be construed accordingly.

Section 16(2A) TCGA requires a claim to be made when the loss accrues (which may be some years before the loss is used):

> A loss accruing to a person in a year of assessment shall not be an allowable loss for the purposes of this Act unless, in relation to that year, he gives a notice to an officer of the Board quantifying the amount of that loss; and sections 42 and 43 of the Management Act shall apply in relation to such a notice as if it were a claim for relief.

In this chapter I assume losses are allowable unless otherwise stated.

40.3 Loss accruing to non-resident

Section 16(3) TCGA provides:

> A loss accruing to a person in a year of assessment during no part of which he is resident or ordinarily resident in the UK shall not be an allowable loss for the purposes of this Act unless, under section 10 or 10B, he would be chargeable to tax in respect of a chargeable gain if there had been a gain instead of a loss on that occasion.

In short, a loss accruing to a person who is neither resident nor ordinarily resident in the UK is not an allowable loss. This gives a symmetry with the principle that a gain accruing to such a person is not in principle subject to CGT. Section 16(3) refers to a "person", so it applies to individuals, trustees, companies and PRs. However, there is some relief for non-resident trusts within s.86, 87 TCGA; see below; there is also some relief for losses of non-resident companies within s.13 TCGA; see 39.19 (Loss accruing to non-resident company).

The realisation of losses outside the scope of CGT is wasteful. Unless the temporary non-residence rules apply:

(1) An individual leaving the UK may consider realising losses before he becomes non-resident.
(2) An individual planning to come to the UK may postpone the disposal of assets with inherent losses until he acquires UK resident status.[2]

40.4 Carry-back of losses on death

Section 62(2) TCGA provides for carry-back of losses on death:

> Allowable losses sustained by an individual in the year of assessment in which he dies may, so far as they cannot be deducted from chargeable gains accruing in that year, be deducted from chargeable gains accruing to the deceased in the 3 years of assessment preceding the year of assessment in which the death occurs, taking chargeable gains accruing in a later year before those accruing in an earlier year.

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2 This assumes that the temporary non-residence rules and s.10 TCGA do not apply. For the year of arrival and departure, see 6.18.1 (Losses).

Section 62(2A) TCGA provides:

> Amounts deductible from chargeable gains for any year in accordance with subsection (2) above shall not be so deductible from any such gains so far as they are gains that are treated as accruing by virtue of section 87 or 89(2) (read, where appropriate, with section 10A).

Thus the disallowance of personal losses against s.87 deemed gains continues on death. That is consistent with the general rule.

40.5 Loss accruing to non-resident trustees

40.5.1 *Section 87 and trust losses*

Section 87(4) TCGA provides:

> The section 2(2) amount for a tax year is—
> (a) the amount upon which the trustees would be chargeable to tax under section 2(2) for that year if they were resident and ordinarily resident in the UK in that year ...

Under this definition, losses accruing to trustees in a tax year could be set against gains accruing to the trustees in the same year, in computing the s.2(2) amount. But losses of an earlier year in which the trustees were not resident could not be carried forward and set against gains of a later year, because s.16(3) TCGA disallows such losses.[3] However s.97(6) TCGA allows losses to be carried forward:

> Section 16(3) shall not prevent losses accruing to trustees in a year of assessment for which section 87 of this Act or section 17 of the 1979 Act applied to the settlement from being allowed as a deduction from chargeable gains accruing in any later year (so far as they have not previously been set against gains for the purposes of a computation under either of those sections or otherwise).

Carried forward losses will usually be used to reduce s.2(2) amounts of a subsequent year. But if the trust became UK resident they could be set

3 See 40.3 (Loss accruing to non-resident).

against gains to reduce the trustees own liability. A trust is therefore sometimes better than absolute ownership by a remittance basis taxpayer, whose personal losses may be disallowed.

40.5.2 *Section 86 and trust losses*

Under s.86 TCGA the settlor is taxed on what I call "**the s.86 amount**", which is the amount on which trustees would be charged to tax if UK resident.[4] Under this provision losses accruing to trustees in a tax year could be set against gains accruing to the trustees in the same year, in computing the s.86 amount. But losses of an earlier year in which the trustees were not resident could not be carried forward and set against gains of a latter year because s.16(3) TCGA disallows such losses. However para 1(2) sch 5 TCGA provides:

> In construing section 86(1)(e) as regards a particular year of assessment [that is, in order to ascertain the s.86 amount] —
> (a) any deductions provided for by section 2(2) shall be made in respect of disposals of any of the settled property originating from the settlor, and
> (b) section 16(3) shall be assumed not to prevent losses accruing to trustees in one year of assessment from being allowed as a deduction from chargeable gains accruing in a later year of assessment (so far as not previously set against gains).

40.5.3 *Loss accruing before s.86 conditions satisfied*

Para 1(6) sch 5 TCGA provides:

> (6) The following rules shall apply in construing section 86(1)(e) as regards a particular year of assessment ("the year concerned") in a case where the trustees fall within section 86(2)(a)—
> (a) if the conditions mentioned in section 86(1) are not fulfilled as regards the settlement in any year of assessment falling before the year concerned, no deductions shall be made in respect of losses accruing before the year concerned;
> (b) if the conditions mentioned in section 86(1) are fulfilled as regards the settlement in any year or years of assessment falling before the year concerned, no deductions shall be made in respect

4 See 34.7 (Section 86 amount condition).

> of losses accruing before that year (or the first of those years) so falling,
>
> but nothing in the preceding provisions of this sub-paragraph shall prevent deductions being made in respect of losses accruing in a year of assessment in which the conditions mentioned in section 86(1)(a) to (d) and (f) are fulfilled as regards the settlement.

40.5.4 *Loss on disposal before 19 March 1991*

For completeness, para 1(7) Sch 5 TCGA provides:

> In construing section 86(1)(e) as regards a particular year of assessment and in relation to a settlement created before 19th March 1991, no account shall be taken of disposals made before 19th March 1991 (whether for the purpose of arriving at gains or for the purpose of arriving at losses).

40.6 Disallowance of personal losses against s.87 gains

Section 2(4) TCGA provides:

> If chargeable gains are treated by virtue of section 87 or 89(2)[5] as accruing to a person in a tax year ("the relevant deemed gains")—
> (a) subsection (2) has effect as if the relevant deemed gains had not accrued, and
> (b) the amount on which the person is charged to capital gains tax for that year is the sum of—
> (i) the amount given by subsection (2) as it has effect by virtue of para (a), and
> (ii) the amount of the relevant deemed gains.

This is clumsily expressed.[6] The drafting technique is to isolate the "relevant deemed gains" (ie the s.87 deemed gains) from the loss relief in s.2(2) TCGA. The effect is that personal losses may not be set against s.87 deemed gains accruing to the individual.

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5 Section 2(5) TCGA provides: "In subsection (4) the reference to section 87 or 89(2) is to that section read, where appropriate, with section 10A."

6 Section 62(2A) TCGA shows how the point could be clearly expressed; see 40.4 (Carry-back of losses on death).

40.6.1 *Commentary*

The disallowance of personal losses against s.87 deemed gains was introduced in 1998 because of the difficulties of interaction with taper relief. The CG Manual para 34866 provides:

> **Personal losses [June 2005]**
> ... For 1998–99 onwards the beneficiary's personal allowable losses are not available to reduce these attributed gains. It is not possible to identify any particular gain with a capital payment and so the changes introduced for Section 77 and Section 86 gains, see CG34865+, for 2003–04 onwards could not be extended to Section 87 gains.

The repeal of taper in 2008 should have allowed personal losses to be set once again against s.87 deemed gains. Presumably this point was overlooked or perhaps the deliberate decision was made to discourage the use of trusts. It is submitted that the rule disallowing personal losses against s.87 deemed gains should be repealed.

40.7 Personal losses and s.86 gains

Personal losses can be set against s.86 gains under s.2(2) TCGA.

For completeness, s.2(7) TCGA deals with the situation where a settlor has made two or more settlements:

> Where in any year of assessment—
> (a) there are amounts treated as accruing to a person by virtue of section 86,
> (b) two or more of those amounts, or elements of them—
> (i) relate to different settlements,
> (c) losses are deductible from the amounts or elements mentioned in para (b) above but are not enough to exhaust them all,
> the deduction applicable to each of the amounts shall be the appropriate proportion of the aggregate of those losses.
> The "appropriate proportion" is that given by dividing the amount in question by the total of the amounts.

This is only necessary to ascertain what amount can be recovered under the settlor's indemnity against each settlement.

40.8 Loss accruing to remittance basis taxpayer

40.8.1 *"Foreign loss" and "UK loss"*

The legislation distinguishes between foreign losses and other losses. Section 16ZA(6) TCGA gives "**foreign loss**" a commonsense meaning:

> In this section "foreign loss" means a loss accruing from the disposal of an asset situated outside the UK.

In this discussion, "**UK loss"** means a loss which is not a foreign loss, ie a loss on a disposal of a UK situate asset.

40.8.2 *History*

The complex rules can be better understood if one understands the constraints faced by the drafter. It is difficult to think of a satisfactory rule for losses of a remittance basis taxpayer. Relief for all losses is too generous when only some of the gains are taxable. Relief for foreign losses remitted to the UK is not satisfactory, as it would usually be easy to remit the losses to the UK, so that amounts to a relief for (almost) all losses, at least for a well advised taxpayer. Moreover in the case of the extinction of an asset there may be nothing to remit.

The pre-2008/09 solution was to disallow relief on foreign losses on foreign domiciliaries (to whom the remittance basis applied compulsorily – there was no claim needed). The CGT remittance basis was a package with advantages and this disadvantage. This was a rough and ready solution, but simple and workable. However the introduction of the claim for the CGT remittance basis in 2008 changed the situation. If foreign losses of foreign domiciliaries were disallowed only in years that the individual claimed the remittance basis, then an individual may then claim the remittance basis in the year that he realises gains and may not do so in the year that he realises losses. On the other hand, the failure to claim would often be expensive in other ways, and as a simple and pragmatic solution it has much to commend it.

The FD draft clauses 2007 proposed to disallow all foreign losses of foreign domiciliaries, but that was unlawful (not to mention unfair). HMRC presumably agreed, and a new solution had to be devised in the rushed weeks between publication of the FD draft clauses and the Finance

Bill, allowing insufficient time for HMRC to consider the issues, and none at all for consultation.

40.8.3 *Summary*

EN FB 2008 provides this summary:

> 355. The overall effect of these new rules is that:
> [1] on the first occasion when a non-UK domiciled individual claims remittance basis for a tax year, the individual may make an election in relation to their foreign losses;
> [2] if the individual does not make an election, foreign losses of that tax year and all future tax years will not be allowable losses; and
> [3] if the individual makes an election, special rules apply to the deduction of allowable losses where there are foreign chargeable gains.
> 356. The effect of the special rules is that:
> [1] where foreign chargeable gains are remitted to the UK in a tax year later than that in which the asset was disposed of,
> [a] no losses of that later year, or of any year later than that in which they arose, are deductible from those gains, and
> [b] they may not be covered by the AEA [annual exempt amount] of the year in which they are remitted; and
> [2] if remittance basis is claimed for the tax year in which foreign chargeable gains arise, the allowable losses available for deduction from gains of that year are deducted
> [a] first from foreign chargeable gains that both arise and are remitted in that year,
> [b] then against foreign chargeable gains arising but not remitted in that year, and
> [c] only then from any other (non-foreign) chargeable gains arising in that year.

40.8.4 *Relevant tax year*

The legislation uses the expression “**relevant tax year**”. Section 16ZA(1) TCGA provides:

> In this section “the relevant tax year”, in relation to an individual, means the first tax year for which—
> (a) section 809B of ITA 2007 (claim for remittance basis) applies to the individual, and

(b) the individual is not domiciled in the UK.

Thus the relevant tax year is the first year that the individual claims the remittance basis (it does not matter whether or not the 8-year rule is met, ie whether or not the remittance basis charge is due). One can put off the relevant year by:

(1) arranging to fall within s.809D (non-taxpayer); or
(2) not making a remittance basis claim;

but that is not generally going to be worthwhile. In most cases the relevant tax year will be 2008/09 or the earliest year of UK residence if later.

40.8.5 *Loss election*

Section 16ZA TCGA provides:

> (2) An individual may make an election under this section for the relevant tax year (in which case sections 16ZB and 16ZC have effect in relation to the individual for the relevant tax year and all subsequent tax years). ...
> (4) Sections 42 and 43 of the Management Act (procedure and time limit for making claims), except section 42(1A) of that Act, apply in relation to an election under this section as they apply in relation to a claim for relief.
> (5) An election under this section is irrevocable.

Thus a taxpayer claiming the remittance basis has a once in a lifetime opportunity to make an election under s.16ZA (which I call a "**loss election**") and this election (if made) applies for the rest of his life. It is impossible to know what will be the best choice and the taxpayer will have to guess. This is almost unprecedented in tax legislation.

RDRM chapter 1 p.27 provides:

> The election should be made for the first year for which the remittance basis is claimed, irrespective of whether the individual has any foreign chargeable gains or overseas losses in that year. The election will usually be made within the white space in the Capital Gains supplementary pages of the same SA Return as the first remittance basis claim is made.

The election is irrevocable.
The usual time limits for claims/elections at TMA70/s42 and 43 apply.

40.9 Disallowance of foreign losses if no election is made

Section 16ZA(3) TCGA provides:

> If an individual does not make such an election, foreign losses accruing to the individual in
> [a] the relevant tax year, or
> [b] any subsequent tax year except one in which the individual is domiciled in the UK
> are not allowable losses.

In short, if no election is made, foreign losses accruing to a foreign domiciliary are not allowable. UK losses are allowable in the usual way.

Section 16ZA(5) only applies to foreign losses accruing in the relevant tax year. What about foreign losses accruing before 2008/09? The answer is that such losses would normally be disallowed under s.16(4) TCGA as it had effect before 2008/09:

> In accordance with section 12(1), losses accruing on the disposal of assets situated outside the UK to an individual resident or ordinarily resident but not domiciled in the UK shall not be allowable losses.[7]

40.9.1 *Planning*

It may sometimes be possible for a foreign domiciliary in this position to avoid this problem by taking action before disposing of an asset on which a loss will accrue. Consider:

(1) making assets UK situate prior to disposal;[8]
(2) an inter-spouse transfer.[9]

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7 This wording is confusing. It means that losses accruing to a foreign domiciliary on a disposal by the foreign domiciliary of foreign situated property are not allowable. It does not mean that losses are not allowable on a disposal (by any person) to a foreign domiciliary.

8 Contrast 36.6 (CGT planning: making UK situate property non-UK situate).

9 See 37.12 (Inter-spouse transfers).

A foreign domiciliary who claims the remittance basis may be worse off than if he had not made the claim, if (1) he fails to make the loss election (2) he realises disallowed foreign losses; and (3) he remits sufficient gains to the UK.

40.10 Position if loss election is made

In the following discussion:

"**Promptly remitted gains**" means foreign gains taxed on the remittance basis which are remitted in the year that the gains accrue. "**Postponed remitted gains**" means foreign gains taxed on the remittance basis which are remitted in a year after the gains accrue. Statute calls these "relevant gains." (It is generally better to adopt statutory terminology, for better or for worse, but my terminology is so much clearer than "relevant gains" that it makes the discussion easier to follow.)

"**Unremitted gains**" means foreign gains taxed on the remittance basis which are not remitted (and so not subject to CGT).

Section 16ZB TCGA provides:

> **16ZB Individual who has made election under section 16ZA: foreign chargeable gains remitted in tax year after tax year in which accrue**[10]
> (1) This section applies to an individual for a tax year ("the applicable tax year") if—
> (a) the individual has made an election under section 16ZA,
> (b) foreign chargeable gains[11] accrued to the individual in or after the relevant tax year (within the meaning of section 16ZA) but before the applicable tax year, and

10 Sic: the heading is incoherent.

11 This expression has its usual commonsense meaning. Section 16ZA(6) TCGA provides: "In subsection (1) 'foreign chargeable gains' has the meaning given by section 12(4)." (The drafter should have made this a TCGA-wide definition, in which case s16ZA(6) would not have been necessary.)

(c) by reason of the remission[12] of any of the foreign chargeable gains to the UK, chargeable gains are treated under section 12 as accruing to the individual in the applicable tax year ("the relevant gains").

The key terms here are
– *relevant tax year* (the first year the remittance basis is claimed).[13]
– *relevant gains*. Relevant gains are in my terminology **postponed remitted gains**.
– *applicable tax year* (the year – after the relevant tax year – in which the postponed remitted gains are remitted).

In short, s.16ZB applies if there are postponed remitted gains. At this point the drafting becomes exceptionally clumsy.[14]

Section 16ZB(2) TCGA continues:

> Section 2(2) or (4) has effect for the applicable tax year as if the relevant gains had not accrued.

Section 16ZB(2) isolates the postponed remitted gains from the loss relief in s.2(2) TCGA. Section 16ZB(3) TCGA goes on:

> The amount on which the individual is charged to capital gains tax for the applicable tax year is (instead of the amount given by section 2(2) or (4)(b), as reduced under section 3) the sum of—
> (a) the adjusted taxable amount, and
> (b) the amount of the relevant gains.

40.10.1 *The adjusted taxable amount*

Section 16ZB(4) TCGA provides:

> "The adjusted taxable amount" is—
> (a) if section 3(1) (annual exempt amount) does not apply to the

12 Section 16ZB(6) TCGA provides (somewhat unnecessarily): "For the purposes of subsection (1)(c) foreign chargeable gains are remitted to the UK if they are regarded as so remitted for the purposes of section 12."

13 See 40.8.4 (Relevant tax year).

14 The drafter had adopted the clumsy drafting technique of s.2(4) TCGA which it is helpful to read first, in order to understand s.16ZB; see40.6 (Disallowance of personal losses against s.87 gains).

individual for the applicable tax year, the amount given by section 2(2) or (4)(b) as it has effect by virtue of subsection (2), and

(b) otherwise, so much of that amount as exceeds the exempt amount for the applicable tax year (within the meaning of section 3).

In short, the adjusted taxable amount is the amount of gains less losses (and less the CGT annual exemption if available) apart from the postponed remitted gains.

So in short, if one makes the loss election:

(1) all losses (UK and foreign losses) are allowable against:
  (a) UK gains
  (b) foreign gains if
    (i) taxed on an arising basis (because no remittance basis claim is made in the year that the gains accrue); or
    (ii) promptly remitted gains (remitted in the year that the gains accrue).
(2) under s.16ZB postponed remitted gains do not qualify for:
  (a) *any* loss relief (either UK losses or foreign losses) or
  (b) the CGT annual exemption.

Section 16ZC TCGA relaxes the rule in (2)(a) by allowing some losses against postponed remitted gains:

16ZC Individual who has made election under section 16ZA and to whom remittance basis applies

(1) This section applies to an individual for a tax year if—
  (a) the individual has made an election under section 16ZA for the tax year or any earlier tax year,
  (b) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for the tax year, and
  (c) the individual is not domiciled in the UK in the tax year.

In short, the section applies to a remittance basis taxpayer who makes a loss election.

Section 16ZC continues:

(2) The following steps apply for the purpose of calculating the amount on which the individual is to be charged to capital gains tax for the tax

year.
Step 1 Deduct any relevant allowable losses from the chargeable gains referred to in subsection (3) in the order in which they appear there (starting with para (a) of that subsection).

"Relevant allowable losses" simply means allowable losses. (The drafter is overfond of the word "relevant".) Section 16ZC(7) TCGA provides:

> In this section "relevant allowable losses" means the allowable losses that section 2(2) provides may be deducted from chargeable gains accruing to the individual in the tax year,

40.10.2 *The loss deduction order*

This takes us to s.16ZC(3) TCGA which sets out the deduction order:

> The chargeable gains are—
> (a) foreign chargeable gains[15] accruing to the individual in the tax year, to the extent that they are remitted[16] to the UK in that year,
> (b) foreign chargeable gains accruing to the individual in that year, to the extent that they are not so remitted in that year, and
> (c) chargeable gains accruing to the individual in that year (other than foreign chargeable gains).[17]

So in my terminology, losses are set against gains in this order:

(a) promptly remitted gains;
(b) unremitted foreign gains;
(c) UK gains.

Losses set against (2) are not wasted but they are not used until the unremitted gains are remitted.

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15 Section 16ZC(7) TCGA provides the standard definition: "In this section ... 'foreign chargeable gains' has the meaning given by section 12(4)".

16 Section 16ZB(6) TCGA provides (somewhat unnecessarily): "For the purposes of subsection (3) foreign chargeable gains are remitted to the UK if they are regarded as so remitted for the purposes of section 12."

17 For completeness, s.16ZC(5) TCGA provides: "Chargeable gains treated as accruing under s.12 are not within subsection (3)(c)" – though I do not see why it was necessary to say that – it seems clear in any event.

40.10.3 *Use of deductions*

Our journey takes us to Step 2:

> *Step 2* Treat the amount referred to in section 2(2) or (4)(a) or 16ZB(3)(a) as being equal to—
> (a) the amount it would be if there were no relevant allowable losses, minus
> (b) the total amount deducted under Step 1 from chargeable gains within subsection (3)(a) or (c).

For completeness, s.16ZC(4) TCGA provides:

> Chargeable gains treated as accruing under section 87 or 89(2) (read, where appropriate, with section 10A) are not within any paragraph of subsection (3).

This maintains the disallowance of personal losses against s.87 gains.[18] Section 16ZD TCGA provides:

> (1) This section applies if section 16ZC applies to an individual for a tax year.
> (2) Any allowable loss deducted under step 1 of section 16ZC(2) is to be regarded (for the purposes of section 2(2)(b)) as allowed as a deduction from chargeable gains accruing to the individual in the tax year.
> (3) If a deduction is made under step 1 of section 16ZC(2) from a foreign chargeable gain within section 16ZC(3)(b), the amount of the foreign chargeable gain is reduced by the amount deducted.

40.10.4 *Insufficient losses*

Step 1 continues:

> If allowable losses are deductible from the chargeable gains referred to in subsection (3)(b) but are not enough to exhaust them all—
> (a) those chargeable gains are to be ordered according to the day on which they accrued,

18 See 40.5 (Disallowance of personal losses against s.87 gains).

(b) the losses are to be deducted from those gains in reverse chronological order (starting with the last chargeable gain to accrue), and

(c) if allowable losses are deductible from chargeable gains that accrued on a particular day but are not enough to exhaust all of the chargeable gains that accrued on that day, the amount deducted from each of those chargeable gains is the appropriate proportion of the losses.

In para (c) "the appropriate proportion", in relation to a chargeable gain, is the amount of that gain divided by the total amount of the chargeable gains that accrued on the day in question.

40.10.5 *Planning*

The record-keeping from 2008 is extremely onerous. Before 2008 a taxpayer had only to keep a total of brought forward losses and remitted gains. But now (if a taxpayer makes a loss election) he needs to keep track of which year losses accrue, and which day and year postponed remitted gains accrue, in order to apply these loss rules.

40.11 When is a loss election worthwhile?

Careful timing of realisation of losses and of remittances is necessary in order to maximise loss relief if a loss election is made. A few general points can be made.

A person who will realise UK losses and not foreign losses should not make a loss election.

A person who will realise UK losses and foreign losses, but can use inter spouse transfers to avoid disallowable foreign losses should not make an election.

A person who will realise foreign losses and not UK losses should make an election.

In other cases is it a matter of guesswork.

40.12 Inter-spouse transfer

Suppose a foreign domiciled individual ("H") owns a foreign situate asset which will give rise to a loss. It will often happen that:

(1) The loss on the disposal by H will not be allowable.

(2) If
(a) H gives the asset to his spouse ("W") and
(b) W disposes of the asset
then W will realise an allowable loss (for instance W may not have made a remittance basis claim).

In principle, W can realise an allowable loss. However s.16A TCGA provides:

> **16A Restrictions on allowable losses**
> (1) For the purposes of this Act, "allowable loss" does not include a loss accruing to a person if—
> (a) it accrues to the person directly or indirectly in consequence of, or otherwise in connection with, any arrangements, and
> (b) the main purpose, or one of the main purposes, of the arrangements is to secure a tax advantage.
> (3) For the purposes of subsection (1) it does not matter—
> (a) whether the loss accrues at a time when there are no chargeable gains from which it could otherwise have been deducted, or
> (b) whether the tax advantage is secured for the person to whom the loss accrues or for any other person.[19]

"Tax advantage" has the standard definition. Section 16A(2) TCGA provides:

> "tax advantage" means—
> (a) relief or increased relief from tax,
> (b) repayment or increased repayment of tax,
> (c) the avoidance or reduction of a charge to tax or an assessment to tax, or
> (d) the avoidance of a possible assessment to tax,
> and for the purposes of this definition "tax" means capital gains tax, corporation tax or income tax.

Looking at the words of the section, one would think that the position was

19 What is the point of s.16A(3)(b) TCGA? How can a tax advantage be secured for any person *other* than the person to whom the loss accrues? The answer is if the loss accrues to a non-resident company or trustee, for the tax advantage might be enjoyed by a settlor (under s.86) or a beneficiary (under s.87) or a participator (under s.13). But this is not relevant to inter-spouse transfers.

as follows. An allowable loss is a relief and so a "tax advantage." So if one of the main purposes of an inter-spouse transfer is to obtain the loss, the loss is disallowed. Of course it depends on the precise facts whether that is actually a main purpose, but in many (I think, most) cases it would be so. HMRC rightly say in relation to identifying the main purpose:

> 16. Hence it will be relevant to draw a comparison in order to consider whether, in the absence of the tax considerations:
> • the transaction giving rise to the advantage would have taken place at all;
> • if so, whether the tax advantage would have been of the same amount; and
> • whether the transaction would have been made under the same terms and conditions.

It will very often be the case that the inter-spouse transfer is made only for tax reasons and would not be made in the absence of tax. However, HMRC say:

> 17. ... Nor will the new legislation *ordinarily* prevent a genuine loss on a real disposal of an asset from being set off against a person's own gains, including the case where, before the real disposal that gives rise to the genuine loss, the person acquires the relevant asset from a spouse or civil partner at no gain/no loss under section 58 [TCGA].[20]

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20 "Avoidance of tax through the creation and use of capital losses: HMRC Guidance." This guidance passed swiftly through two draft versions (12 December 2006, 1 May 2007) to the current guidance of 19 July 2007 accessible *www.hmrc.gov.uk/cgt/cgt-recent-developments.pdf* and reprinted (with variations) in the CG Manual Appendix 9. See too example 5:
"40. Mr H has shares in S plc which are standing at a loss. Mrs H has shares in a separate company, T plc, standing at a gain. Mr H transfers his shares to Mrs H under the no-gain, no-loss rule in section 58 TCGA, and she then sells both holdings of shares. The loss on the shares in S plc covers the gain arising from the shares in T plc, and so no CGT is payable by Mrs H.
41. Taking the spouses together, Mr and Mrs H each have shares which they want to sell. What happens in fact is that they do sell their shares, and the economic consequence is that they realise a gain on one set of shares and a loss on the other set. To decide whether or not the TAAR applies, it is necessary to consider whether there have been arrangements, and whether a main purpose of those arrangements was the securing of a tax advantage. In this case, it seems clear that there have been arrangements, namely the transfer of the shares from Mr H to Mrs H. It is then necessary to look at what the main purpose of Mr and Mrs H in entering into these arrangements was. This can be determined only by looking at all the circumstances

(Emphasis added)

According to this, s.16A does not apply to genuine losses, and the loss in the case under discussion is genuine.

The first question this raises is: what is meant by genuine loss and why is the spouse's loss genuine? At first the unlawyerlike term "genuine" seems almost impossible to pin down, but I suggest that the concept intended here is the tax avoidance/mitigation distinction.[21] A loss is genuine (in the intended sense) if it is in accordance with the intention of Parliament, a special tax regime, and has economic consequences. The inter-spouse transfer in principle meets those criteria. This view is confirmed by para 5 of the Guidance Note:

> 5. The effect of the legislation will be to restrict the use of capital losses resulting from the arrangements where *tax avoidance is* the main purpose or one of the main purposes of the arrangements.

Likewise para 17:

> The straightforward use of a statutory relief does not of itself bring arrangements within the TAAR.

The straightforward use of a statutory relief could obviously be done with the purpose of obtaining a tax advantage, but it is not tax avoidance.

The guidance at para 17 uses the word "ordinarily". When will it not apply? An example is if there is an arrangement under which the donee spouse immediately returns the proceeds of the disposal to the donor spouse. In that case the inter-spouse gift has no "economic consequences".

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surrounding the arrangements. In the present example, Mr and Mrs H wanted to dispose of their shareholdings, and they did this in a straightforward way. They made use of the provisions of section 58 TCGA, which provides the opportunity for spouses (or civil partners) to bring together gains and losses, but again the straightforward use of a statutory relief in this way does not (of itself) bring arrangements within the TAAR. Moreover, the tax outcome of the transactions reflects the economic reality of Mr and Mrs H's situation. In all the circumstances, this suggests that there was no main purpose of achieving a tax advantage, and where there is no such main purpose the rule does not apply."

But the factual inference in the last sentence is implausible, for the reasons explained above.

21 See 21.17.3 ("Genuine").

The next difficulty is to reconcile that guidance with the words of the statute. One might simply give up at this point:

> We think that the words "**tax avoidance**" should be substituted for "**tax advantage**"... the guidance contradicts the legislation. Some transactions (such as transfers between spouses) are stated in the guidance not to be caught by the TAAR,[22] when it is strongly arguable that they are caught.[23]

If that is right, then the decision whether or not to apply the legislation in relation to inter-spouse transfers (and indeed many other cases) is made by HMRC with no redress by the taxpayer (outside judicial review discussed below). However, it is suggested, having regard to *Pepper v Hart*, that the reference to "tax advantage" should be read to mean tax avoidance in the strict sense. The fact that the definition here is based on words which in other contexts have been understood differently[24] does not determine the issue.

The reader may wonder whether this discussion matters, given that HMRC have stated that they will not normally challenge the transfer of losses by inter-spouse transfers. On a constitutional level it matters to those who believe that tax should be based on law and not concession and discretion. On a practical level it matters if HMRC later decide to change their practice (which as the IR20 debacle shows is not a theoretical possibility) or if they chose to apply it inconsistently.

The IFS commentary deserves to be set out in full:

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22 A note on terminology. The label which HMRC give to anti-avoidance provisions of the s.16A type is *targeted* anti-avoidance rule (**"TAAR"**). This terminology was coined by HMRC and first used in a press release of 5 December 2005. The term has become so degraded that the Institute for Fiscal Studies can say without obvious irony that "TAARs need to be well targeted ... costs can outweigh the expected amount of lost revenues when a poorly targeted TAAR is compared with a well-targeted TAAR". The same report refers later to a "wide-ranging TAAR". Countering Tax Avoidance in the UK, TLRC discussion paper no.7, March 2009, para 8.18 accessible *www.ifs.org.uk/comms/dp7.pdf.*

23 Response of CIOT to consultation (8 February 2007).

24 See 20.14.1 (Subsidiary consequence not necessarily a purpose).

> 7.4 However, the width of this relatively simple provision [s.16A TCGA] meant that HMRC needed to publish 17 pages of detailed Explanatory Notes to explain how the legislation would be applied. So, considering the example of the person who sells shares standing at a loss in order to set the loss against a gain on another disposal, the Explanatory Notes explain that this transaction will not be prevented, albeit that the legislation could be used to prevent this.
> 7.5 There are several problems with this approach. First, the Explanatory Notes are not themselves subject to the scrutiny and care in drafting given to legislation. By their nature, Explanatory Notes are not drafted in the precise way required for legislation.
> 7.6 Second, HMRC does not have the power to legislate: taxation can only be imposed by the legislature[25] and while HMRC may decide upon its own interpretation of the legislation, that interpretation is not binding on taxpayers save to the extent confirmed by the courts. 'HMRC's role is to administer the UK's tax and customs systems.'
> 7.7 Third, the ability of taxpayers to rely on the guidance depends upon the type of transaction involved: if it is a single transaction entered into in reliance on specific guidance, the taxpayer can rely on the guidance (although enforcement may be cumbersome, for the reasons explained below). In contrast, if the taxpayer is seeking to rely on guidance in relation to a continuing state of affairs, the taxpayer is exposed to changes in that guidance. ...

40.12.1 *Is the HMRC guidance enforceable?*

The reader may regard these constitutional fundamentals as irrelevant to practice, but the IFS then turn to discuss the important issue of whether the guidance is enforceable:

> 7.8 To enforce guidance, the taxpayer must seek judicial review. Judicial review is a process that is costly and time consuming and which is not easily achieved. In order for a taxpayer to seek judicial review, an application for leave to apply for judicial review must be made within three months of the decision that is being challenged. The application is made to the High Court by a form setting out the grounds of the

25 [footnote original] Article 4 Bill of Rights 1689: ["That levying money for or to the use of the Crown by pretence of prerogative, without grant of Parliament, for longer time, or in other manner than the same is or shall be granted, is illegal."]

application and an affidavit setting out the factual background. Clearly, three months is an extremely short deadline even for the well-advised taxpayer. If the judge considers that the papers show an arguable case, leave to apply for judicial review is granted, but after this initial tight timescale matters may then move very slowly.

7.9 Consequently, a major drawback of judicial review at present is that it is effectively unavailable to most potential applicants: they do not know about it, cannot understand it, cannot afford it, or find the prospect of going to the High Court too daunting. This situation would be improved if the new Tribunals, which will handle tax appeals from 2009, have jurisdiction to review the exercise of discretionary acts by HMRC and review the application of HMRC guidance.[26]

7.10 In addition to the procedural and costs issues, the ability of taxpayers to use judicial review in the context of non-legislative rule-making is not always clear. It is beyond the scope of this paper to set out in detail the present state of the law with regard to the use of judicial review in relation to the exercise of powers by HMRC. However, certain points are addressed below, as the limits of challenge may be increasingly important as new ways of tackling avoidance are explored by the government.

7.11 In the context of this paper, the key issues limiting the ability to challenge by way of judicial review concern the application of judicial review to situations where HMRC has issued guidance to taxpayers generally regarding the application of legislation.

7.12 First, there are situations where HMRC guidance appears to differ from the conclusion that would be reached just by reading the legislation. An example of this arises in connection with the wide-ranging capital gains tax TAAR found in Section 16A TCGA 1992, where the legislation could be read to apply much more widely than HMRC maintains is the case in its Explanatory Notes. Where the HMRC treatment is recognised by HMRC as being a concession from the strict reading of the law, then there is the system of extra-statutory concessions. Even these raise issues of enforcement. The judiciary has frequently indicated that it is uncomfortable with the concessions system: for example, "One should be taxed by law and not be untaxed by concession".[27]

7.13 That said, extra-statutory concessions have been upheld by the courts (although they are not enforceable in cases of avoidance). At the same time, the courts have decided that the power to grant them should only be exercised as part of HMRC's duty of care and management. This was

26 The hope that the new Tribunals will improve the position has not been realised.
27 [Footnote original] Walton J in *Vestey v IRC (No. 2)* [1979] 3 WLR 915.

made clear in the case of *R (on the application of Wilkinson) v. IRC* where the Court of Appeal held that the Inland Revenue had no power to grant a concession to overrule an unequivocal piece of legislation unless this could be said to "facilitate the overall task of collecting taxes". As a result of this case, the government announced that the power to make concessions from the strict application of tax law is not as wide as had previously been thought and consequently the concessions are being reviewed to determine those that are not within HMRC's powers of "collection and management". Section 160 of the Finance Act 2008 gives the Treasury power to make any existing concession statutory by order. In so doing, it defines an existing concession to include a statement of any sort – whether it is described as an extra-statutory concession, a statement of practice, an interpretation, a decision, a press release or in any other way – that provides a concession that a taxpayer would not, or may not, be entitled to under the law. This power of the Treasury only applies to existing concessions. Going forward, HMRC's administrative powers have been limited by the Wilkinson case.

7.14 More difficulty is posed by statements made by HMRC that explain the legislation and are not considered by HMRC to deviate from the legislation. What if a taxpayer considers that HMRC's guidance is wrong in law? The taxpayer could rely on making their argument through the courts, but that raises enormous cost issues and risk issues for the taxpayer. Alternatively, the taxpayer could seek judicial review on the basis that the HMRC treatment as shown by the guidance was "ultra vires". However, in order to seek judicial review, the taxpayer also needs to show that they have sufficient interest in the matter to qualify them to make the application. These are high hurdles (albeit not impossible, as cases such as *R v Department of Social Security ex p. Overdrive Credit Card Ltd*[28] show) and it must be asked whether many taxpayers would feel confident of passing these hurdles or be prepared to spend the money in order to do so. If the answer to that is that very few would, then effectively HMRC is legislating by default.

7.15 The other potential source of problems in HMRC guidance is the guidance changing. Usually, the reason given for a change in guidance is that HMRC has been advised that its guidance is wrong in law. Again, judicial review is potentially available, but the case of *R v C&E Commissioners ex parte F & I Services* held that while a taxpayer could rely on the legitimate expectation generated by guidance, that expectation is limited to circumstances where reliance has been placed on the changed

28 [1991] STC 129.

> statement. In that case, a VAT clearance for a voucher scheme was withdrawn following a change in view of the Customs and Excise as to the operation of the law. The taxpayer had incurred expense on the introduction of the scheme. It was stated by Lord Justice Sedley that "the law recognises no legitimate expectation that a public authority will act unlawfully. It is only where the expectation is of a particular exercise of managerial discretion that the court will begin to examine its legitimacy."[29]
> 7.16 Consequently, this paper maintains that the more tax rules are dealt with by way of non-legislative methods, the more exposed taxpayers become to these limited forms of redress. Government should only permit the increased use of non-legislative rule-making if the problems highlighted here are adequately tackled. ... [30]

Scope for judicial review is in my view even weaker than the IFS here suggest, for Guidance Note para 24 is intended to give HMRC freedom to disregard their own guidance note (or at least to give freedom to decide when it should or should not apply, which comes to the same thing):

> Examples of how the legislation will apply in particular circumstances are set out below. These examples are intended to show how different factors will be taken into consideration in deciding whether or not the TAAR applies in a given set of circumstances. They are not designed as templates for deciding whether a loss is or is not caught by the TAAR in any particular case.

Thus unless my view on the construction of s.16A TCGA is adopted, the guidance is for all practical purposes unjusticiable. The position is not so much that HMRC are above the law, but that there is no law, only discretion. The uncertainty caused by provisions such as s.16A (which apply to corporation tax as well as CGT) is a major factor which encouraged companies such as WPP, Shire, Regus, Henderson, Charter, Beazley, Brit Insurance and UBM to leave the UK for Ireland or Switzerland.[31] Nevertheless, HMRC regard the provision as "successful"[32]

29 [2001] BTC 5266 at p.5283.

30 Countering Tax Avoidance in the UK, TLRC discussion paper no.7, March 2009, accessible *www.ifs.org.uk/comms/dp7.pdf*.

31 A majority of Main Survey respondents (23) expressed exasperation with the complexity and unpredictability of current anti-avoidance rules, all but one asserting that this was a phenomenon hindering the competitiveness of the UK

(which in the sense of preventing avoidance it no doubt is). So the current position will continue until HMRC change their view that preventing tax avoidance is a priority that trumps other policy considerations such as the need for certainty and the rule of law.

economy. Freedman et al, Alternative Approaches to Tax Risk and Tax Avoidance: analysis of a face-to-face corporate survey (September 2008) accessible *ideas.repec.org/p/btx/wpaper/0814.html*.

32 OECD "Engaging with High Net Worth Individuals on Tax Compliance" May 2009 para 135; see *www.oecd.org/dataoecd/5/25/42798312.pdf*.

CHAPTER FORTY ONE

DOUBLE TAXATION RELIEFS FOR INCOME TAX AND CGT

41.1 DT reliefs - Introduction

A full discussion of DT reliefs would need many volumes. I concentrate here on the interaction of treaty rules with UK tax legislation, and not on the terms of the treaties.[1] Discussion is based mainly on the OECD model treaty though I refer at points to the US treaty and others. In any particular case the DTT concerned would need to be reviewed.

41.1.1 *Types of DT relief*

We need terms for the various types of DT relief, and in this chapter I use the following terminology.

"DT exemption" applies where a DTT[2] provides an exemption from tax. There are of course countless DT exemptions but the wording is fairly standard: it states that income or gains of certain kinds "shall be taxable only in" the foreign state. For example, Art.11(1) Netherlands DTT provides:

> Interest arising in one of the States which is derived and beneficially owned by a resident of the other State shall be taxable only in that other State.

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1 See too 28.5 (DTT relief for partnership); for the accrued income scheme, see 25.15 (DTT relief).

2 A note on terminology. The terms DT treaty/convention/arrangement/agreement are synonymous. The OECD Model use the word "convention" but "treaty" seems clearest.

"Foreign tax credit relief" arises where foreign tax is set against UK tax. This may be **"DTT tax credit"** where a DTT confers a credit or "**Unilateral tax credit"** where UK tax law (not a DTT) confers a credit. "**IT/CGT computation deduction**" applies where foreign tax is deducted in computing income or gains.

I refer to all these reliefs together as **"DT reliefs"**.

41.1.2 *Types of residence and significance of DT reliefs*

I use the term **"treaty-residence"** to mean residence for the purposes of a DTT, and "**domestic-law residence"** residence for UK tax purposes (it is essential in this chapter to distinguish the two.) Where a person is resident in the UK for UK law purposes, I describe them as **"domestic-law UK resident."** Where a person is treaty-resident outside the UK, I generally refer to them as **"treaty-resident outside the UK"** (rather than the statutory terminology sometimes used, which is "treaty non-resident"). These are clumsy terms but it is difficult to think of better.

DT reliefs matter to all individuals, but different classes of individual are interested in different aspects of the reliefs. The permutations can be summarised in a table:

	Domestic-law UK resident	Treaty-resident outside UK
Case 1	N	Y
Case 2	Y	Y
Case 3	Y	N

(1) Individuals who not domestic-law UK resident. As non-residents they are in principle subject to IT on UK source income only. If treaty-resident outside the UK they may qualify for relief on some of those liabilities (eg relief for UK source interest under the Netherlands DTT mentioned above).

(2) Individuals who are domestic-law UK resident. As UK residents they are in principle subject to IT or CGT on all UK and foreign income and gains (subject where applicable to the remittance basis). If treaty-resident outside the UK (under the tie-breaker rules) they may qualify for exemptions from UK and foreign source income and gains. This category

has become much more important from 2008/09, for two reasons. First, many individuals who would formerly have simply claimed the remittance basis will now find it cheaper to claim treaty relief, as a remittance basis claim will incur the remittance basis charge. Secondly following the abandonment of IR20 and its replacement by the hopelessly vague HMRC 6, many more individuals will find that they may possibly be domestic-law UK resident and since they might be UK resident they may claim treaty relief just in case.
(3) Individuals who are domestic-law UK resident and not treaty-resident outside the UK. These do not directly qualify for any DT exemption but they may qualify for foreign tax credit relief (or IT/CGT computation deduction.) They may also qualify for indirect DT relief if income or gains accruing to a trust or company which is treaty-resident outside the UK are deemed to accrue to them under an anti-avoidance provisions such as s.624, TAA, s.13, s.86, etc.

41.1.3 *Interaction of DT reliefs and the remittance basis*

The commentary to Art.1 of the OECD model treaty provides:

> 26.1 Under the domestic law of some States, persons who qualify as residents but who do not have what is considered to be a permanent link with the State (sometimes referred to as domicile) are only taxed on income derived from sources outside the State to the extent that this income is effectively repatriated, or remitted, thereto. Such persons are not, therefore, subject to potential double taxation to the extent that foreign income is not remitted to their State of residence and it may be considered inappropriate to give them the benefit of the provisions of the Convention on such income. Contracting States which agree to restrict the application of the provisions of the Convention to income that is effectively taxed in the hands of these persons may do so by adding the following provision to the Convention:
>
> > "Where under any provision of this Convention income arising in a Contracting State is relieved in whole or in part from tax in that State and under the law in force in the other Contracting State a person, in respect of the said income, is subject to tax by reference to the amount thereof which is remitted to or received in that other State and not by reference to the full amount thereof, then any relief provided by the provisions of this Convention shall apply only to so much of the income as is taxed in the other Contracting State."

Although this text was only added to the OECD Commentary in 2003, some provision of this kind is standard in UK DTTs. A provision of this kind is included in the US DTT, on which the IRS comment:

> For example, if a UK resident who is not domiciled in the UK maintains a brokerage account in Ireland into which is paid $100 in U.S.-source dividend income, the United States may impose withholding tax at the statutory rate of 30 percent because the dividend income will not be taxed in the UK as it has not been remitted to the UK. If the dividend income instead is paid into a brokerage account in London, the UK resident will be subject to tax in the UK and the United States will reduce the rate of withholding tax to 15 percent.[3]

Note that it is US tax, not UK tax, which is in issue here. UK tax issues would only arise if the UK entered into a treaty with another country where the other country has a remittance basis. The only example of which I am aware is the treaty with Ireland.

41.2 Incorporation of DTTs into UK law

International treaties (including DTTs) do not automatically become part of UK law, but must be incorporated into UK law by statute. Accordingly, s.788(3) ICTA provides:

> Subject to the provisions of this Part, the arrangements [DTTs] shall, notwithstanding anything in any enactment, have effect in relation to income tax and corporation tax in so far as they provide—
> (a) for relief from income tax, or from corporation tax in respect of income or chargeable gains; or ...
> (c) for determining the income or chargeable gains to be attributed—
> (i) to persons not resident in the UK and their agencies, branches or establishments in the UK; or
> (ii) to persons resident in the UK who have special relationships with persons not so resident; ...

3 Department of the Treasury Technical Explanation of the Convention.

DTT relief is extended to CGT by s.277(1) TCGA.[4]

41.3 Foreign tax credit relief

41.3.1 *DTT tax credit*

For example, art.22 Australia DTT provides (with immaterial exceptions):

> Australian tax payable under the laws of Australia ... on income or chargeable gains from sources within Australia .. shall be allowed as a credit against any UK tax computed by reference to the same income or chargeable gains by reference to which the Australian tax is computed;

41.3.2 *Unilateral tax credit*

Section 790(1) ICTA provides:

> To the extent appearing from the following provisions of this section, relief from income tax and corporation tax in respect of income and chargeable gains shall be given in respect of tax payable under the law of any territory outside the UK by allowing that tax as a credit against income tax or corporation tax, notwithstanding that there are not for the time being in force any arrangements under section 788 providing for such relief.

Section 790(2) ICTA provides statutory terminology (not used in this book):

> Relief under subsection (1) above is referred to in this Part as "unilateral relief".

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4 "For the purpose of giving relief from double taxation in relation to capital gains tax and tax on chargeable gains charged under the law of any territory outside the UK, in Chapters I and II of Parts XVIII of the Taxes Act, as they apply for the purposes of income tax, for references to income there shall be substituted references to capital gains and for references to income tax there shall be substituted references to capital gains tax meaning, as the context may require, tax charged under the law of the UK or tax charged under the law of a territory outside the UK."

I prefer the term **“unilateral tax credit”**, which seems clearer.

Section 790(3) ICTA incorporates the relief by reference:

> [a] Unilateral relief shall be such relief as would fall to be given under Chapter II of this Part if arrangements in relation to the territory in question containing the provisions specified in subsections (4) to (10C) below were in force by virtue of section 788, but subject to any particular provision made with respect to unilateral relief in that Chapter; and
> [b] any expression in that Chapter which imports a reference to relief under arrangements for the time being having effect by virtue of that section shall be deemed to import also a reference to unilateral relief.

Section 790(4) at last sets out the relief:

> (4)[a] Credit for tax paid under the law of the territory outside the UK and computed by reference to income arising or any chargeable gain accruing in that territory shall be allowed against any UK income tax or corporation tax computed by reference to that income or gain ...

For the issue of where income arises, see 14.3 (Non-resident trader rules).

41.3.3 *Quantum of income/gains*

The INT Manual provides:

> **165030. Computation –assessable amount** [December 2006]
> Where credit is claimed against UK Income Tax for foreign tax paid on income from a foreign source, the amount of that income for all UK tax purposes is:
> ***a) Foreign income assessable on the arising basis***
> No direct foreign tax is to be deducted. Where, exceptionally, the double taxation agreement provides for relief for underlying tax on a dividend (seeINTM164410) the underlying tax should be added to the amount of the income. Treat the whole of a foreign pension as chargeable to UK tax notwithstanding the deduction of one tenth under Section 65(2) ICTA 1988.
> *Example:*
> An individual receives a dividend of 100 from which 15 foreign withholding tax was deducted. The amount of income assessable is 100.

b) Foreign income assessable on the remittance basis
Add the amount of direct foreign tax attributable to the amount of income remitted. Where, exceptionally, the agreement provides for relief for underlying tax on a dividend (see INTM164410), the underlying tax should also be added to the amount of the dividend remitted. If you have difficulty in determining the amount of foreign tax attributed to income remitted, refer to the Offshore Personal Tax Team (part of Charity, Assets & Residence).
Example

[Gross foreign income]	£1,000
Foreign tax	£400
Net foreign income	£600
Remitted to UK	£300

UK measure of the income	
Income remitted	£300
Plus foreign tax (300/600 x 400)	£200
Therefore UK measure is	£500

This summarises the rules in s. 795 ICTA. Similarly for CGT. The INT Manual provides:

169080. Remittance basis [December 2006]
An individual who is resident or ordinarily resident but not domiciled in the UK and who makes a chargeable gain on the disposal of an asset situated outside the UK is only liable on the amount of the gain received in the UK (Section 12 TCGA 1992 see CG25300 onwards). When such an individual is chargeable on the gain received in the UK and claims credit for foreign tax charged on the same gain, the liability in the UK will be on the sum of the amount remitted to the UK plus the foreign tax attributable to the amount remitted.
Any difficulty in determining the correct addition for the foreign tax, should be referred to the Offshore Personal Tax Team (part of Charity, Assets & Residence).

41.3.4 HMRC practice: quantum of relief

The INT Manual provides:

169100. Amount of foreign tax credit relief – general

Similar principles to those set out in INTM161210 onwards for Income Tax apply to Capital Gains Tax. The amount of credit for foreign tax is not to exceed the lesser of the foreign tax charged on the foreign gain and the UK tax charged on the doubly taxed gain at the taxpayer's marginal rate.

If the foreign tax exceeds the UK tax, the excess can neither be deducted from the amount of the gain chargeable to Capital Gains Tax, nor can it be repaid.

The foreign tax should not be increased by any indexation allowance.

A taxpayer's marginal rate for Capital Gains Tax is the rate at which the tax is charged for the year of assessment.

169110. Amount of foreign tax credit relief –more than one gain

The amount of foreign tax credit relief must be calculated separately for each gain. An excess of foreign tax over UK tax on one gain cannot be credited against UK tax on another foreign gain or on the gain on the disposal of a UK asset.

169120. Amount of foreign tax credit relief –losses

Allowable losses should be set firstly against chargeable gains on which no foreign tax credit relief is due. It would normally be to the taxpayer's advantage to set any balance of losses, in order, against the gains on which the lowest level of foreign tax has been paid. This should secure the maximum amount of foreign tax credit relief.

169130. Amount of foreign tax credit relief –exemption from tax

Where the total of the chargeable gains in any year of assessment exceeds the exempt amount provided by TCGA 1992 Section 3, the exempt amount should, as far as possible, consist of gains on which no foreign tax has been charged. This will enable credit for foreign tax charged on the gains to be allowed against the UK Capital Gains Tax charged on those gains.

The following example demonstrates the application of this paragraph and of INTM169120

In 2002–03, an individual has the following chargeable gains:

UK	£8,000	
Country X	£20,000	Foreign tax £4,000
Country Y	£6,000	Foreign tax £2,700

He has losses of £6,000 available for deduction. The exemption limit for 2002–03 is £7,700. The computation of his liability is as follows:

	UK Gain	Country X Gain	Country Y Gain
	£8,000	£20,000	£6,000
Less Loss	£6,000		
	£2,000	£20,000	£6,000
Less Exempt Amount	£2,000	-£5,700	
	0	£14,300	£6,000
Tax at 40%	0	£5,720	£2,400
Less Foreign Tax Credit Relief	0	£4,000	£2,400
Tax Payable	Nil	£1,170	Nil

The balance of Country Y's tax of £300 (2,700 less 2,400) cannot be set off against the Capital Gains Tax payable on the Country X gain and cannot be repaid.

169140. Amount of foreign tax credit relief – extent to which a gain is doubly taxed

As mentioned in INTM169100, credit for foreign tax cannot exceed the UK tax due on the doubly taxed gain. There may be situations where the amount of the UK gain is different from the amount of the gain that is taxed in the other country; or where the period of ownership of the asset that is taken into account in computing the UK gain is different from the period of ownership of the asset that is taken into account in computing the gain in the other country. In either case, the amount of the foreign tax allowable for foreign tax credit relief may need to be restricted. For further details on this, see CG14395 –CG14425.

169150. Amount of foreign tax credit relief – basis of allowance [December 2006]

Credit may be claimed for the foreign tax paid on foreign capital gains against the UK tax due on the same gain, irrespective of the tax year in which the foreign tax is charged.

Where credit is claimed on any other basis or where there are difficulties in determining the amount of foreign tax credit relief due, advice may be sought from the Offshore Personal Tax Team (part of Charity, Assets & Residence).

41.4 CGT/IT computation deduction

Section 278(1) TCGA provides:

Subject to
[a] section 277 and to

> [b] section 111 of the Finance Act 2004 (computation of chargeable gains subject to special withholding tax),
> the tax chargeable under the law of any territory outside the UK on the disposal of an asset which is borne by the person making the disposal shall be allowable as a deduction in the computation of the gain.

The reference in [a] is a reference to s.277(3) TCGA:

> So far as by virtue of this section capital gains tax charged under the law of a territory outside the UK may be brought into account under the said Chapters I and II as applied by this section, that tax, whether relief is given by virtue of this section in respect of it or not, shall not be taken into account for the purposes of those Chapters as they apply apart from this section.

Thus foreign tax credit relief (if claimed) has priority over a CGT computation deduction.

At first sight it is not obvious when a CGT computation deduction would be better than foreign tax credit relief. One case is where foreign CGT is payable but UK CGT is not (because of a difference in valuation rules or because some UK relief applies.) In such a case the computation deduction may increase the loss allowable for UK CGT purposes (similarly for IT). But that must be a rare case.

The INT Manual provides:

> **169090. Deduction not credit**
> A deduction for the foreign tax should be made in the computation of the gain or loss, when there is no claim to foreign tax credit relief or when no UK tax is chargeable on a gain; for example, when the UK computation shows a loss on the disposal and consequently there is no UK tax against which credit for any foreign tax can be given. No deduction is due, however, when credit relief is claimed, for any part of the foreign tax paid on a gain which does not qualify for credit because it exceeds the UK tax chargeable on the same gain.

Similarly, for IT s.811 ICTA provides:

> **811 Deduction for foreign tax where no credit allowable**
> (1) For the purposes of the Tax Acts, the amount of any income arising in any place outside the UK shall, subject to subsection (2) below, be treated as reduced by any sum which has been paid in respect of tax on

that income in the place where the income has arisen (that is to say, tax payable under the law of a territory outside the UK).
(2) Subsection (1) above—
(a) shall not apply to income the tax on which is to be computed by reference to the amount of income received in the UK; and ...
(d) shall not require any income to be treated as reduced by an amount of underlying tax which, by virtue of section 799(1B)(b), falls to be left out of account for the purposes of section 799;
and this section has effect subject to section 795(2) and to section 111 of the Finance Act 2004 (computation of income subject to special withholding tax).

INT Manual provides:

161050. Deduction instead of credit [March 2007]
It may sometimes be to the taxpayer's advantage not to make a claim to tax credit relief, for example where a trader's Case I profits are wholly covered by capital allowances so that there is no Income Tax or Corporation Tax payable on those profits, or where the trading results show a loss. If, for any reason, tax credit relief is not claimed, the foreign tax paid must be deducted from the income from the foreign source in computing the amount of the income for UK tax purposes (Section 811 ICTA 1988). This may serve to create or increase a loss which can be dealt with under the normal provisions for losses.
Section 811 refers to 'any sum which has been paid in respect of tax' on income. This means tax alone and not, for example, interest paid in the foreign country for late payment of the foreign tax. Nor may a deduction be allowed for 'tax spared' (INTM161270) as it is not tax which has been paid; nor for underlying tax (INTM164060 and INTM164360) as it is not paid on the dividend in question; nor for taxes similar to UK VAT (see, however, INTM161080). Refer to CT & VAT, International CT, any case where it is not clear that the tax for which a deduction is sought under Section 811 is a tax on income.
Section 811 allows a deduction for foreign tax paid on income 'in the place where the income has arisen'. Refer to CT & VAT, International CT, any case where a deduction is sought for foreign tax paid on income which arises wholly or partly from work carried out in the UK.
Some foreign taxes, if not deductible under Section 811, may still be allowable expenses in computing the profits of a trade or profession (see INTM161080, BIM45900 onwards).

41.5 Indirect DT reliefs

41.5.1 *Can a third party claim a DT exemption?*

DT exemptions are not in principle restricted to the person who is treaty-resident outside the UK. If (as is standard form) a DT exemption provides that income shall be taxable only in the foreign state, a settlor or transferor in the UK cannot be taxable on that income. Section 788(3)(a) ICTA authorises DT exemptions to apply in this way, for it simply provides "relief", ie relief for anyone.[5] I refer to this as **"indirect DT exemption"**.

This is self-evident, but authority can be cited if necessary. In *Lord Strathalmond v IRC*,[6] US source income arose to Lady Strathalmond. The rule in those days (only repealed in 1988) was that income of a married woman was deemed to accrue to her husband, so in the absence of treaty relief, Lord Strathalmond would have been taxable. The wife was treaty-resident in the US but the husband was not. Nevertheless he was entitled to DT exemption. The treaty exempted the income, not the treaty-resident individual, so a third party otherwise taxed on the income could claim the benefit of it even though not treaty-resident. Lord Millett summarised the point:

> [*Strathalmond*] shows that the relief from UK tax accorded by a double taxation agreement can enure for the benefit of a third party.[7]

Again, in *Padmore v IRC*[8] a partner was entitled to DT exemption on income of a Jersey partnership where the partnership was treaty-resident in Jersey but the partner was not.

Again, in *Smallwood v HMRC*[9] a settlor was entitled to DT exemption against a charge under s.77 TCGA on gains accruing to a settlor-interested trust where the trustees were treaty-resident in Mauritius and the settlor was not.

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5 One might also refer to s.788(3)(c)(ii) ICTA; but DTTs usually take the form of providing relief, rather than the form of disattributing income otherwise attributable to a settlor or transferor.

6 48 TC 537.

7 *Bricom v IRC* 70 TC at p.290.

8 62 TC 352.

9 [2009] STC 1222.

I stress this because there is a comment to the contrary by the Special Commissioner in *IRC v Willoughby*[10] but that must be dismissed as erroneous. HMRC did not seek to argue to the contrary in *Smallwood*.

41.5.2 *Can a third party claim foreign tax credit relief?*

The position is the same for DTT tax credit. The position is the same for unilateral tax credit, because s.790 allows "relief" or "credit" i.e. relief and credit for anyone.

The ITH provides:

> **Tax charged on different person**
> **618. General**
> There is no requirement in the credit rules that the person charged to the UK tax is to be the same as the person charged to the foreign tax. The rules simply demand that the income or gains subjected to the foreign tax be the same income or gains as are subject to the UK tax.
> **619. Capital gains**
> An example of this situation is found in Section 140 TCGA 1992 which deals with the charge on capital gains where a branch or agency overseas is domesticated, that is to say transferred to a non-resident company in exchange for shares. In those circumstances a charge on the gains on branch assets transferred is deferred until either the transferor sells the shares or the transferee sells the assets (in the latter case the sale has to be within six years of the acquisition). In that latter instance where the transferee sells the asset, any foreign tax on the gains is paid by the transferee. But the UK company is charged in respect of the capital gains on those same assets and qualifies for credit relief because the gain has been taxed abroad, although the tax has actually been charged on the transferee.
> A similar situation could occur with transfers under Section 171 TCGA 1992 between UK group companies. If the assets involved are situated abroad and the foreign tax authority taxes the UK company making the transfer, the benefit of that tax can be taken by the transferee group company when there is a disposal outside the group generating a UK tax charge on the relevant asset.

10 [1995] STC 143 at p.169.

620. Income
On the income side a similar situation could occur where a UK resident is required to be assessed on income which in fact is the income of some other person and has been taxed abroad.

The INT Manual makes the same point:

169040. Gain taxed UK/abroad
In determining whether UK tax is computed by reference to the same gain on which the foreign tax is charged, there is no necessity that the respective tax liabilities should arise at the same time or that they should be charged on the same person. Thus, the same gain is regarded as taxed both overseas and in the UK where, for example:

· overseas tax is payable on a no gains/no loss disposal within a UK group of companies and liability to UK tax arises on the subsequent disposal of the asset taking in the uplift in value to the date of the first disposal under TCGA 1992 Section 171

· where an overseas trade carried on through a UK branch or agency is transferred to a local subsidiary the gain on the related disposal of the chargeable assets may immediately be crystallised for local tax purposes but deferred under TCGA 1992 Section 140 until the shares in the local subsidiary are sold (or the subsidiary disposes of the assets within six years) thus giving rise at that point to a gain chargeable to UK tax computed in whole or in part by reference to the earlier uplift in value

· overseas tax is payable by reference to increases in the value of assets although there has been no disposal and there is a subsequent disposal attracting UK liability

· overseas tax is payable in its country of residence by a non-resident company on the disposal of an asset and in the UK the gain is charged on a UK resident individual under TCGA 1992 Section 13 (see INTM169060).

In each case, the amount of relief may need to be restricted under the rules set out in INTM169100 onwards.

Where, by contrast, it is not possible to identify the gain subject to overseas tax with that on which UK liability arises, no credit relief is due. Thus, where overseas tax is charged on a disposal covered by rollover relief under TCGA 1992 Section 152 and liability to UK tax arises on the disposal of the replacement asset, the gain on that disposal cannot be identified with the gain on the earlier disposal and no credit relief is due. A deduction for the overseas tax may, however, be allowed under TCGA 1992 Section 278 (INTM169090) in computing the gain for rollover purposes.

SP 6/88 provides:

Double taxation relief: chargeable gains

General

1 TCGA 1992 s 277 applies to capital gains tax the double taxation provisions set out in TA 1988 ss 788–806, with the necessary modifications. TA 1988 s 797 applies the provisions to corporation tax on chargeable gains.

2 The standard credit article in our double taxation agreements (which are made under TA 1988 s 788) says, in effect, that subject to the provisions of the law of the UK, tax payable under the law of the treaty partner on capital gains from sources within that territory shall be allowed as credit against any UK tax computed by reference to the same gains by reference to which the overseas tax is computed. TA 1988 s 790 allows unilateral relief for overseas tax and s 790(4) is in similar terms to the standard credit article.

3 The principal requirement for the granting of credit for overseas tax against liability to capital gains tax (or corporation tax on chargeable gains) is therefore that the overseas tax should be computed by reference to the same gain as the UK tax. There is no requirement that the respective tax liabilities should arise at the same time nor that they should be charged on the same person.

Specific examples

4 The Revenue's view is that the following sets of circumstances fall within the terms of the standard credit article and TA 1988 s 790 and may therefore give rise to a credit for overseas tax against UK capital gains tax or corporation tax on chargeable gains.

(i) The overseas tax charges capital gains as income.

(ii) Overseas tax is payable on a disposal falling within TCGA 1992 s 171 (transfers within a group of companies treated as taking place on a no gain/no loss basis) and a liability to UK tax arises on a subsequent disposal.

(iii) An overseas trade carried on through a branch or agency is domesticated (ie transferred to a local subsidiary) and relief is given under TCGA 1992 s 140. There is a subsequent disposal of the securities (or the subsidiary disposes of the assets within six years) giving rise to a liability to UK tax and overseas tax is charged in whole or in part by reference to the gain accruing at the date of domestication.

(iv) Overseas tax is payable by reference to increases in the value of assets although there has been no disposal. There is a subsequent disposal of the assets on which a liability to UK tax arises.

> 5 It will be seen that relief is conditional upon the subject of the overseas tax being identified with the gains on which the UK tax liability arises. In contrast, where roll-over relief is claimed, for example under TCGA 1992 s 152, the gain on disposal of the old asset is not subjected to UK tax. The gain on realisation of the new asset remains a gain separate from that realised on sale of the old asset and overseas tax payable as a result of the sale of the old asset is not creditable against UK tax payable on the gain realised on sale of the new asset. However, in such circumstances TCGA 1992 s 278 allows the overseas tax to be claimed as a deduction in computing the gain for roll-over relief purposes.

This raises the issue of characterisation.

41.6 The characterisation issue

DT reliefs provide relief for particular types of income, and so relief only applies if the taxpayer receives that type of income. The characterisation of income in the hands of the UK taxpayer is a central question. I refer to this as **"the characterisation issue"**.

Hughes v Bank of New Zealand[11] concerned exemption for interest on gilts, not a DTT, but the characterisation issue is not restricted to DT reliefs: it can arise wherever an exemption applies to a particular type of income. This case concerned a non-resident bank with a UK branch whose profits were taxable. The branch's trading receipts included interest from exempt gilts (exempt from UK tax in the hands of a non-resident). The interest retained its exemption. Lord Millett summarised:

> [*Hughes*] is authority for the proposition that exempt interest retains its character as interest even when it is taxable as a component element of the recipient's trading profits. ... Interest from exempt securities does not cease to be such by being included as a component element of the recipient's taxable profit.[12]

On the other side of the line, according to Lord Millett, is *IRC v*

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11 21 TC 472.

12 *Bricom v IRC* 70 TC at p.290. Nowadays the exemption for gilts is restricted so as not to apply in this type of case.

Australian Mutual Provident Society.[13] This concerned a non-resident life assurance company with a branch in the UK whose profits were taxable. The taxable profits were calculated in an unusual way: the relevant rule provided that an unidentifiable portion of the world-wide income of the company derived from the investment of its life assurance fund, calculated in accordance with a mathematical formula, should be charged to tax as income derived from business in the UK. It was held that the rule did not tax the company's investment income as such but something different, described as "a conventional sum calculated in accordance with the rule"; the sum to be taxed was not interest, even though interest from exempt gilts represented one of the elements in the calculation.

The characterisation issue often arises in cases where indirect DTT relief is sought (though it is not restricted just to such cases). Assuming the income in the hands of the treaty-resident recipient third party qualifies for DT relief, is the income which the UK taxpayer receives (or better, is deemed to receive) the *same* income? Or has the income "changed its character" (in which case DT reliefs do not apply)?

IRC v Willoughby offers an example. Here the transferor paid a premium to a life assurance company which was treaty-resident in the Isle of Man. Under s.720 he was (in principle) subject to tax on the income accruing to the life assurance company from the premium. The IOM DTT provided relief for the commercial profits of the life assurance company; but the income on which the taxpayer was subject to tax could not be characterised as the commercial profits of the life assurance company; his income was merely one (in the context of the whole, trivial) element by reference to which those profits were computed. So for this reason (there could be others) the transferor could not claim indirect DTT relief.[14]

Millett LJ summarised:

> ... the question turns on the nature of the statutory process... where tax is charged on a conventional or notional sum which exists only as the product of a calculation, the fact that one of the elements in the calculation is measured by reference to the amount of exempted income does not make the exempted income the subject of the tax: *Australian*

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13 28 TC 388 "as explained by Lord Radcliffe" in *Ostime v Australian Mutual Society* [1960] AC 459 at p.479, 38 TC 492.

14 Though this is not quite the way that the Special Commissioner dealt with the point: 70 TC 57 at p. 90. The taxpayer wisely did not appeal on the DTT issue.

Mutual Provident Society.[15]

41.6.1 *The correct approach to characterisation*

Where income accrues to A, and a statutory provision provides that income deemed to accrue to B, the provision may or may not change the character of the income, that is, B's income may or may not be a different type from A's income. It is a question of construction.

In straightforward cases, where B's deemed income is exactly equivalent to A's actual income, it is suggested that the courts should normally conclude that the legislation does not change the character of the income. That is, if there is a change in the character of the income, the legislation needs to say so directly or by implication. One reason that this is the case is that otherwise there would be a breach of the treaty. DTTs are not construed technically: if a DTT provides income is exempt, Parliament has power to breach the treaty and tax that income; it may do so expressly or by mere implication. But changing the character of the income is as much a breach of the treaty as directly taxing the income. While the UK can deliberately breach a treaty, tax legislation should be construed consistently with a treaty where possible.

A second reason is that in a simple case where B's deemed income is exactly equivalent to A's actual income, there is no rational distinction to be drawn between one income and equivalent income.

This is consistent with a purposive approach. Lord Steyn said:

> The tendency should therefore generally speaking be against literalism. What is literalism? It will depend on the context. But an example is given in The Works of William Paley... the tyrant Temures promised the garrison of Sebastia that no blood would be shed if they surrendered to him. They surrendered. He shed no blood. He buried them all alive. This is literalism. If possible it should be resisted in the interpretative process.[16]

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15 *Bricom v IRC* 790 TC at p.290. *Ibid.*

16 *Sirius International Insurance v FAI General Insurance* [2004] 1 WLR 3251 at [19]. But see "The Problem is the Perception" David Goldberg QC, *GITC Review* Vol. 4 No. 2 accessible *www.taxbar.com* for a defence of Temures ("Of course, the garrison should have been advised by a lawyer before accepting the surrender terms.")

It is worth stepping back to remember that the purpose of double tax treaties is to allocate taxing rights between countries.

41.6.2 *Bricom*

Bricom v IRC concerned a claim for indirect DT exemption where:

(1) Income accrued to a subsidiary company treaty-resident outside the UK.
(2) The parent company was domestic-law UK resident and not treaty-resident outside the UK.
(3) The parent company was in principle subject to tax under the Controlled Foreign Company ("CFC") provisions.

The CFC provisions operate in three stages:

> Stage 1. *Ascertainment:* the CFC's chargeable profits are ascertained .
> Stage 2. *Apportionment:* the CFC's chargeable profits (less any creditable tax) are apportioned among its shareholders. In *Bricom* the CFC was a wholly-owned by the taxpayer, so all its chargeable profits were attributed to the taxpayer.
> Stage 3. *Assessment:* The taxpayer is assessed on "a sum equal to corporation tax at the appropriate rate on that apportioned amount of profits" (less the apportioned amount of creditable tax) and the sum assessed is recoverable from the taxpayer "… as if it were an amount of corporation tax chargeable on the taxpayer".

The Special Commissioners held that interest received by the CFC lost its character as interest at stage 1. Millett LJ disagreed:

> It is ... a reflection of the Revenue's unsuccessful argument in *Hughes,* viz: that interest from exempt securities loses its character as income by being included in the computation of the recipient's trading profits.

So far so good. But the interest lost its character at stage 2:

> The correct analysis is that the interest received by Spinneys [the CFC] is not included in the sum apportioned to the taxpayer on which tax is chargeable. It merely provides a measure by which an element in a conventional or notional sum is calculated, and it is that conventional or

> notional sum which is apportioned to the taxpayer and on which tax is charged....

The CFC case was on the wrong side of the distinction because "the chargeable profits" as defined by s.747(6)(a) are *a notional sum.* Why are they more notional than the profits of any company?

> They do not represent any profits of Spinneys on which UK corporation tax is chargeable, for there are no such profits.

Obviously correct, but not relevant. The question is not whether the CFC income of the taxpayer represents profits of the CFC *on which UK corporation tax is chargeable*. The question is whether it represents the profits of the CFC (or more accurately, whether its type is the same as those profits). The judgment then turns to this:

> Nor do they represent any actual payments or receipts of Spinneys, whether of interest or anything else.

Why not?

> They are merely the product of a mathematical calculation made on a hypothetical basis and making counterfactual assumptions.[17] The "chargeable profits" which are defined by s.747(6)(a) exist only as a measure of imputation. What is apportioned to the taxpayer and subjected to tax is not Spinneys' actual profits but a notional sum which is the product of an artificial calculation.

The mere fact that taxable profits are ascertained by a mathematical calculation does not by itself change the character of the profits. The amount of profits on which corporation tax is charged is in every case the product of a mathematical calculation.

The decision in *Bricom* is authority for the following propositions:

(1) The application of DT reliefs requires that the income of the taxpayer is the same income as that which qualifies for relief. (This is right and

17 Millett wisely does not state what the hypothetical and counterfactual assumptions are: one must assume that the CFC is UK resident.

could not be doubted.)
(2) The characterisation issue is a matter of construction of the relevant provisions.
(3) The CFC provisions did alter the character of the income received by the taxpayer. This decision does not, it is submitted, shed a great deal of light on the question of construction of the other provisions considered in this chapter.

One would like to think that the unfairness of *Bricom* was a factor in the ECJ decision that the CFC legislation was contrary to EU law.[18] That would have been just.

41.6.3 *Four types of deeming*

Tax provisions often use the word "deem" or its plain English equivalent, "treated as". When considering the characterisation issue in relation to deeming provisions, it is important to bear in mind that there are several different fictions that deeming provisions may be used to achieve:

(1) *Deeming as to recipient:* Statute may deem that whereas income actually arose to A, it is deemed to arise to B.
(2) *Deeming as to time:* Statute may deem that whereas income actually arose at one time, it is deemed to arise at another time.
(3) *Deeming as to quantum:* Statute may deem that whereas the amount of income which actually arose to A was £x, it is deemed to be of a different amount, £y.
(4) *Deeming as to character:*
    (a) Statute may deem that whereas income which actually arose was of type A, the taxpayer is deemed to receive income of another type (type B).
    (b) Statute may deem that whereas what arises is gains, it is deemed to be income.
    (c) Statute may deem that whereas no income or gains arise to anyone, the taxpayer is deemed to receive income or gains.

Case (1) does not by itself change the character of the income. This is (I

18 See 42.3 (Restriction on freedom of establishment).

think) self-evident, but there is authority:

> Exempt income does not change its character or lose its exemption merely because it is deemed to be the income of another person or is imputed to him: *Strathalmond.*[19]

The same applies if the UK provision apportions income to the taxpayer: "apportion" has the same meaning as "deems to accrue to" or "impute".[20] The term "attribute" is also the same.[21]

Likewise in cases (2) and (3) DT reliefs will still apply.

In case (4)(a) DT relief applicable to type A income only (not type B income) will not exempt the taxpayer. Cases (4)(b)(c) need further consideration.

So the mere fact that the legislation uses the terminology or technique of deeming does *not* mean that DT reliefs cease to apply. One must ask what is the deeming, and in particular, is it deeming as to the character of the income?

41.6.4 *"An amount equal to" the income*

In *Bricom*:

> The taxpayer lays stress on the fact that what is apportioned under s.747(3) is not "a sum equal to the chargeable profits" but the chargeable profits themselves; and that the subject of the charge to tax in s.747(4)(a) is not "a sum equal to the apportioned part of the chargeable profits" but the apportioned part of the chargeable profits itself.

The distinction proposed is between the profits and an amount equal to the profits. The taxpayer (it seems) raised this distinction but it did not help. The characterisation of income may be altered even though the statute does not use the expression "an amount equal to". That is, the absence of that expression does not determine the characterisation issue. The issue is one of construction, and must be decided in the context of the

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19 *Bricom v IRC* 790 TC at p.290.

20 *Bricom v IRC* 70 TC at p.290.

21 The terms "apportion" and "attribute" are used synonymously in s.13 TCGA; see 39.2 (Attribution of gains to participator).

provisions as a whole. Conversely, the use of the expression "an amount equal to" does not conclude the characterisation issue. While it is apt to describe a change of character, it does not necessarily do so. The entire provisions must be considered. I identify below some cases where this phrase is used without changing the character of the income. Indeed, a distinction between income and an amount equal to the income strikes me as a distinction without a difference, a foolish distinction to introduce into tax jurisprudence, which is bound to lead to confusion, muddle and uncertainty.

41.7 DT reliefs and remittance basis gains of individual

After this lengthy theoretical discussion, we can turn to some practical questions. Section 12 TCGA provides:

> (1) This section applies to foreign chargeable gains accruing to an individual in a tax year ("the foreign chargeable gains") if—
> (a) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for that year, and
> (b) the individual is not domiciled in the UK in that year.
> (2) Chargeable gains are treated as accruing to the individual in any tax year in which any of the foreign chargeable gains are remitted to the UK.
> (3) The amount of chargeable gains treated as accruing is equal to the full amount of the foreign chargeable gains so remitted in that year.

Art.13(5) OECD Model Convention provides (with immaterial exceptions):

> Gains from the alienation of any property ... shall be taxable only in the Contracting State of which the alienator is a [treaty-resident].

Suppose:

(1) a remittance basis taxpayer is domestic-law UK resident and treaty-resident outside the UK.
(2) the taxpayer gains which are in principle subject to CGT.

Can the individual claim DT relief? This raises a characterisation issue. (The individual is not claiming indirect treaty relief but as noted, the characterisation point is not restricted to that.) However, everyone agrees that DT exemption applies to gains taxable on the remittance basis. Section 12(2) TCGA imposes a deeming as to time that is, the gains which actually accrue on disposal are deemed to accrue when remitted, and s.12(3) imposes a deeming as to amount. The character of the gains is not altered. That is, the chargeable gains which are "treated as accruing" are the actual gains which accrued to the individual, and not different (notional) gains.

41.7.1 *Timing: interaction with remittance basis*

DT relief requires in principle that the alienator is treaty-resident outside the UK at the time the gain accrues.[22] What if the gain is a foreign gain of a remittance basis taxpayer? The gain is deemed to accrue at the time that the gain is remitted. If that deeming applies for DT purposes, then odd consequences would follow. In the following examples, assume that foreign gains accrue to a remittance basis taxpayer who is domestic-law UK resident throughout. Suppose two cases:

(1) The individual is not treaty-law resident outside the UK when the gains accrue but is treaty-law resident when the gains are remitted.

(2) The individual is treaty-law resident outside the UK when the gains accrue but is not treaty-law resident when the gains are remitted.

If the deeming applies for DT purposes, DT relief applies in case (1) and not in case (2). That is absurd. It would often lead to double taxation or double non-taxation. So it is considered that the deeming does not apply for DT purposes, so DT relief can apply in case (2) but not in case (1).

41.8 DT reliefs: s.624 ITTOIA

Foreign tax credit relief

Foreign tax credit relief in principle applies for the benefit of a settlor within s. 624: s.623 ITTOIA provides:

> For the purpose of calculating liability to tax under this Chapter (but for no other purpose), a settlor shall be allowed the same deductions and reliefs as if any amount treated under this Chapter as income of the

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22 *Smallwood v HMRC* [2009] STC 1222.

settlor had actually been received by the settlor.

The INT Manual considers the position where a beneficiary is taxed in the UK and a settlor is taxed in some other country under a foreign provision equivalent to s.624:

> **161040. Same income**
> The credit Article in an agreement and the corresponding provision for unilateral relief in ICTA 1988 Section 790(4) are concerned with relief from double taxation on income or gains. For credit to be allowed, it is not a requirement that the foreign tax on income or gains has to be borne by the same person who is liable to UK tax on the same income or gains. For example, if the foreign country taxes a settlor on the income of a UK resident beneficiary, who is chargeable to UK tax on that income, credit may be given to the beneficiary for the foreign tax paid by the settlor. However, it must be the same income which is being taxed in both countries...

41.8.1 *Trustees treaty-resident outside UK*

This section considers whether DT exemption can be available where:

(1) income accrues to a settlor-interested trust treaty-resident outside the UK
(2) the settlor is domestic-law UK resident and not treaty-resident outside the UK
(3) the settlor is in principle subject to tax under s.624.

Section 619 and 624 ITTOIA must be read together:

> **619(1)** Income tax is charged on—
> (a) income which is treated as income of a settlor as a result of section 624 (income where settlor retains an interest) ...
> **624** Income which arises under a settlement is treated for income tax purposes as the income of the settlor and of the settlor alone...

Section 624 imposes a deeming as to the recipient, that is, the income which actually arises to the trustees is deemed to accrue to the settlor. The character of the income is not altered. That is, the income which is "treated as the income of the settlor" is the actual income of the trustees, and not different (notional) income.[23]

It follows that the settlor can in principle claim indirect DT exemption provided that the income qualifies for the relief.

Why in fact is there a charge to tax under s.619? If the settlor is treated as receiving (say) interest income, the income would be chargeable to tax under the charging provisions relating to interest. No separate charge to tax is needed. The drafter is in my view slightly muddled as to whether the income of the settlor is the settlement income or notional income. He may be forgiven for this, for it is not rational to try to draw a distinction between the two, they amount to exactly the same thing.

It might be argued that since the income is deemed to be the income of the settlor and of the settlor alone, it is deemed not to be the income of the trustees, so the deeming disapplies the DT exemption. But that construction would put the UK in breach of the treaty, so it should not be regarded as correct.

41.8.2 *Settlor treaty-resident outside the UK*

Suppose the trustees are not treaty-resident outside the UK so the settlor cannot claim indirect treaty relief. Suppose however the settlor is domestic-law UK resident but treaty-resident outside the UK. Can the settlor claim DT exemption directly? It is considered that he can.

In some cases DT exemption only applies if the income is "beneficially owned" by the settlor. In the case of a common form settlor-interested discretionary trust, the income is not "beneficially owned" by the settlor as a matter of property law. But since for tax purposes it is deemed to be the income of the settlor, this condition is deemed to be satisfied, at least in the treaty law sense of the expression. The OECD Commentary is helpful here:

> 12 ... The term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

In the USA DTT, this is expressly dealt with: see below.

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23 See 41.5.1 (Can a third party claim a DT exemption?).

41.9 DT reliefs: section 720 ITA

Foreign tax credit relief

Foreign tax credit relief in principle applies for the benefit of the transferor: Section 746 ITA provides:

> (1) This section applies for the purpose of calculating the liability to income tax of an individual charged under section 720 or 727.
> (2) The same deductions and reliefs are allowed as would have been allowed if the income treated as arising to the individual under section 721 or 728 had actually been received by the individual.

41.9.1 *Person abroad treaty-resident outside UK*

This section considers whether DT exemptions can be available where:

(1) Income accrues to a person abroad who is treaty-resident outside the UK.
(2) The transferor is domestic-law UK resident and not treaty-resident outside the UK.
(3) The transferor is in principle subject to tax under s.720.

Under the pre-ITA wording before 2007/08, it is considered that the s.739 ICTA deemed income of the transferor was the same as the income of the person abroad. It follows that the transferor could in principle claim DT exemptions provided that the income qualifies for the relief.[24]

What is the position now under ITA? Sections 720(2) and 721(1) ITA must be read together:

> **720(2)** Income tax is charged on income treated as arising to such an individual under section 721 (individuals with power to enjoy income as a result of relevant transactions).
> **721(1)** Income is *treated as arising* to such an individual as is mentioned in section 720(1) in a tax year for income tax purposes if

24 See the quote from 18.9.1 (Power to enjoy part of income of person abroad). David Goy QC agrees: "Double Tax Treaties and ss.739 and 740 ICTA 1988", GITC Vol. V no.2, accessible *www.taxbar.com*. See too "Double Taxation Treaties: the Antidote to Anti-avoidance Provisions", Robert Venables QC, OTPR Vol. 6 p.151.

conditions A and B are met.

I refer to income treated as arising under s.721 as **"s.720 deemed income"**. The question is whether this is the same as the income of the person abroad.

At first sight the reference to income being *treated* as income of the transferor might be taken to suggest that the s.720 deemed income is different from the income of the person abroad. However this is not the case: the expression "treated as" is neutral, and the deeming may simply be a deeming as to recipient: that the transferor is (contrary to the actual position) treated as entitled to the actual income of the person abroad. The wording is the same as s.624 where that is indeed the position. One needs to review all the provisions to see if there is a deeming as to the character of the income.

In the HMRC view, the s.720 deemed income is *not* the same income as that accruing to the person abroad, so treaty relief is in principle not available for s.720. The ITH provides:

> [1] The anti-avoidance provisions of [sections 720 and 731 ITA] go in that direction, but not far enough to get within the credit rule [foreign tax credit relief], either because
> [a] the income which is assessed on the UK resident cannot be identified with any particular part of the income which the non resident has received or
> [b] because the resident is charged by reference to a benefit received out of the assets rather than on the income itself.
> [2] We take the view that where the UK charge is made on deemed income or gains, such income or gains are not the same income or gains charged abroad.

The argument at [1][a] is not convincing because the s.720 deemed income can easily be identified with the particular part of the income of the person abroad which arises from as a result of the transfer. The argument at [1][b] relates only to s.731, considered below. The argument at [2] is based on the use of the word "deemed" in s.739 (or "treated" in s.720) and is clearly invalid. But it is necessary to look at the entire TAA code to see if the s.720 deemed income is the same as the income of the person abroad.

Rebecca Murray[25] refers to s.721 ITA which continues:

> (2) Condition A is that the individual has power in the tax year to enjoy *income of a person* abroad as a result of … a relevant transfer …
> (3) Condition B is that *the income* would be chargeable to income tax if it were the individual's and received by the individual in the UK.
> (4) For the purposes of subsection (2), it does not matter whether *the income* may be enjoyed immediately or only later.
> (5) It does not matter for the purposes of this section—
> (a) whether *the income* would be chargeable to income tax apart from section 720 …
>
> (Emphasis added)

She argues:

> ... s.721(5) ... appears to close the issue. If the income chargeable under s.720 were only an amount equal to income, it would be impossible to ask the question whether it would be chargeable apart from s.720, since it would just be an amount equal to income only chargeable by virtue of s.720. It must be the same income in order to ask this question.[26]

The references in s.721(2)(3)(4) and (5) are to the actual income of the person abroad, but this does not show that the reference to the s.720 deemed income is the same income.

The pre-2008 s.726 ITA (foreign domicile defence) is more helpful. This provided:

> *(1) An individual is not chargeable to income tax under section 720 in respect of any income treated as arising to the individual under section 721 if conditions A and B are met. ...*
> *(3) Condition B is that if the income had in fact been the individual's income, because of being so domiciled the individual would not have been chargeable to income tax in respect of it.*

This did seem to equate the income treated as accruing with the actual

25 See "TAA provisions and Double Taxation Conventions" 12 PTPR 9 (Robert Venables QC).

26 *Taxation* Vol. 159, 7 June 2007 at p.640.

income of the person abroad. However, the post-2008 s.726 does distinguish between the income of the person abroad and the deemed income:

> (1) This section applies in relation to income treated under section 721 as arising to an individual in a tax year ("the deemed income") if—
> (a) section 809B, 809D or 809E (remittance basis) applies to the individual for the year, and
> (b) the individual is not domiciled in the UK in the year.
> (2) For the purposes of this section the deemed income is "foreign" if (and to the extent that) the income mentioned in section 721(2) would be relevant foreign income if it were the individual's.
> (3) Treat the foreign deemed income as relevant foreign income of the individual.

Section 726(3) is drafted on the assumption that the s.720 deemed income is different from the original income of the person abroad.

Does s.746 ITA (set out above) shed any light on the issue? This supports the argument that DT reliefs to apply to s.720 deemed income because if the income is different the deductions and reliefs would not apply. Section 743(4) ITA also assumes that the s.720 deemed income is the same as the income of the person abroad.

My conclusion is that under ICTA and under the pre-2008 ITA the deemed s.720 income is the same as the actual income of the person abroad. The 2008 reforms move one step towards separating the two types of income, based no doubt on the (in my view mistaken) HMRC view of the pre-2008 legislation. The current legislation is for this reason confused and inconsistent on the issue of whether the income treated as accruing to the transferor is the actual income of the person abroad or merely fictional income.

41.9.2 *Transferor treaty-resident outside the UK*

Suppose the person abroad is not treaty-resident outside the UK so the transferor cannot claim indirect treaty relief. Suppose however the transferor is domestic-law UK resident but treaty-resident outside the UK. Can the transferor claim DT exemptions directly? If the HMRC view is correct, the transferor may do so under the "other income" article, regardless of the type of income which accrued to the person abroad; even if, say, the income of the person abroad is of a type which would not normally qualify for DT exemption. See the discussion below on s. 731. If my view is correct, the DT exemption is available if the type of income of the person abroad qualifies for the exemption.

In some cases DT exemption only applies if the income is "beneficially owned" by the transferor. The point is the same as for s. 624. In a s.720 case the income is not "beneficially owned" by the transferor as a matter of property law. But since for tax purposes it is deemed to be the income of the transferor, this condition is deemed to be satisfied, at least in the treaty law sense of the expression.

In the USA DTT, this is expressly dealt with: see below.

41.10 DT reliefs: s.731 ITA

41.10.1 *Person abroad treaty-resident outside UK*

This section considers whether DT reliefs can be available where:

(1) income accrues to person abroad who is treaty-resident outside the UK
(2) an individual (not the transferor) is domestic-law UK resident and not treaty-resident outside the UK
(3) the individual is in principle subject to tax under s.731.

DT exemption is not applicable for s.731 ITA. ITA EN provides:

> 2170. The method statement [s. 733 ITA 2007] makes it clear that "relevant income" in relation to an individual is not actually taxable income of the individual, but is an element in the calculation of taxable income. "Relevant income" is actual income arising to a person abroad; the income charged under section 731 is income treated as arising to the individual in question. This deemed income may be more or less than "the relevant income of the tax year" in relation to the individual and the tax year identified at Step 3.

That was also the position under the pre-ITA wording. The ITH passage cited above shows that HMRC take this view.

There is no foreign tax credit relief. However, income used to pay foreign tax is not relevant income as it cannot be used to benefit a beneficiary.

41.10.2 *Individual treaty-resident outside the UK*

This section considers whether DT reliefs can be available where

(1) an individual (not the transferor) is domestic-law UK resident and treaty-resident outside the UK
(3) the individual is in principle subject to tax under s.731.

Can the individual claim treaty relief directly? In principle exemption is available under OECD Model Convention Art.21(1) (other income):

> Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

The USA DTT is differently worded. Article 22 provides:

> (1) Items of income beneficially owned by a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention (other than income paid out of trusts or the estates of deceased persons in the course of administration) shall be taxable only in that State.

Is s.731 deemed income "beneficially owned" by the individual? The point is the same as for s.624. The deemed s.731 income is not "beneficially owned" by the individual as a matter of property law. But since for tax purposes it is deemed to be the income of the individual, this condition is deemed to be satisfied, at least in the treaty law sense of the expression. The wording "beneficial ownership" is drawn from the OECD model, and the OECD commentary discussed above is relevant here.

The exclusion relating to trusts should not be relevant here. The Exchange of Notes provides:

> It is understood that the purpose of the exclusion from the paragraph for income paid out of trusts or the estates of deceased persons in the course of administration is to allow a recipient of such income the relief that would have been available to him under the provisions of the Convention had he received the income direct instead of through the trust or estate.'

41.11 DTT relief: s.13 TCGA

In the following discussion I distinguish between 3 types of residence for a company:

Type of residence	Domestic-law UK resident	Treaty-resident in State with DTT with CG article
Treaty non-resident	N[27]	Y
Simple non-resident	N	N
UK resident	Y	N

In this terminology, for instance, a Jersey resident company is *simple* non-resident (the Jersey DTT has no CG article) but a US resident company is *treaty* non-resident.

41.11.1 *Close company treaty non-resident*

Suppose an individual (or a company) owns a treaty non-resident company which realises a gain:

Individual (or company) ("A") *UK resident*

B Ltd *Treaty non-resident*

Section 13(2) TCGA provides that A:

> shall be treated for the purposes of this Act as if a part of the chargeable gain had accrued to him.

The sidenote to s.13 calls this "attribution" of gains. The body of s.13 refers to gains "apportioned" to participators. Section 13(10A) TCGA (repealed) used the words "treated as".[28] It all comes to the same thing.

27 A treaty non-resident company must be non-UK resident in domestic law.

28 Section 13(10A) provided: *A gain which is treated as accruing to any person by virtue of this section shall not be eligible for taper relief.*

This is a deeming as to recipient, and the gain treated as received by A is the same gain as the gain received by B Ltd. A can claim DTT relief for gains accruing to B Ltd (deemed to accrue to A) under s.13 TCGA.

HMRC agree. The CG Manual provides at para 57380:

> **Double taxation agreements**
> You should always check whether there is a double taxation agreement between the UK and the country in which the company making the gain is resident. If there is no double taxation agreement any TCGA 1992, s.13 charge is unaffected. Similarly if the agreement does not refer to capital gains or CGT the charge under TCGA 1992, s.13 is unaffected. But, if the agreement provides that gains of the type realised by the non-resident company are only taxable in that company's country of residence TCGA 1992, s.13 cannot apply. For example, Article 15(4) of the Kenya/UK Double Taxation Agreement[29] would prevent TCGA 1992, s.13 applying to the disposal of stocks and shares by a company resident in Kenya. Agreements will often treat gains on the disposal of particular types of asset differently.[30]

The FA 2008 introduced new terminology. Section 14A(2) TCGA provides:

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29 The Kenyan DTT follows the OECD Model, so what is stated here of Kenya is generally true for DTTs which have a CGT article.

30 Likewise DTR Manual para 1506 provides:
Resident shareholders in non-resident companies
[Section 13 TCGA] enables the UK, in certain circumstances, to tax a UK resident in respect of gains made by a non-resident company in which he is a shareholder (participator where the gains accrue on or after 28 November 1995 – Section 174 FA 1996) (see CG57200 onwards). However the Capital Gains Articles in double taxation agreements may override it.
If the non-resident company disposes of immovable property; for example, land, buildings etc, in the UK, double taxation agreements normally provide that any gain can be taxed in UK. Although UK domestic law may prevent a capital gains tax charge on the non-resident company (see Section 10 TCGA 1992), Section 13 TCGA 1992 can be applied to tax the UK resident shareholder.
If the asset disposed of is not immovable property in the UK; for example, immovable property situated outside the UK, shares etc, then the Capital Gains Article will normally prevent a charge to tax under Section 13 TCGA 1992 being made on the shareholder.
The text of the Capital Gains Article in the agreement with the country concerned will need to be examined to see whether there are any variations from the general principles outlined above.

> The part of the chargeable gain treated as accruing to the individual *("the deemed chargeable gain")* is a foreign chargeable gain within the meaning of section 12 if (and only if) the asset is situated outside the UK.

This does not alter the DTT position: the use of the expression "deemed chargeable gain" does not show that the gain changes its character. The wording reflects the deeming as to recipient and in that sense the gain accruing to the participator can be called a deemed gain. The character of the gain is not altered. That is, the gain deemed to accrue to the participator is the actual gain accruing to the company, and not a different (notional) gain.

The wording does perhaps suggest that the drafter was not conscious of the distinction between the actual gain and an equivalent notional gain, but that is understandable since it is a distinction without a difference.

41.11.2 *Participator treaty non-resident*

Suppose an individual who is domestic-law UK resident but treaty non-resident owns a simple non-resident company which realises a gain:

Individual ("A")	*UK resident treaty non-resident*
B Ltd	*Simple non-resident*

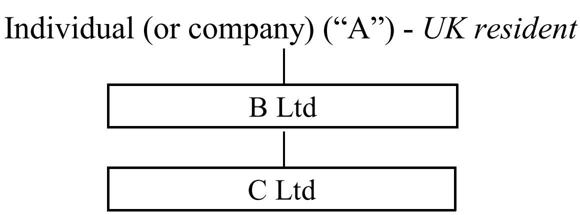
The gain treated as received by A is the same gain as the gain received by B Ltd. But art.13(5) OECD Model Convention provides (with immaterial exceptions):

> Gains from the alienation of any property ... shall be taxable only in the Contracting State of which the *alienator* is [treaty-resident].

It appears that A does not qualify for treaty relief on a gain accruing to B Ltd. A (though treaty non-resident) is not the alienator. B Ltd is the alienator but (on the facts of this example) B Ltd is not treaty non-resident. So the terms of art.13(5) are not satisfied. The US treaty is wider and DT exemption applies to those who are treaty-resident in the US: see 41.17 (USA DTT). Even under the OECD Model, the same result is arguable on the grounds that the gain is treated as accruing to A, he should be deemed to be the alienator; or the word "Alienator" does not require that one must alienate property, only that the gain on the alienation accrues to the person.

41.11.3 *Chain of companies*

Suppose there is a chain of companies:



Suppose a gain accrues to C ("C's gain"). We have the following possibilities:

	Case 1	**Case 2**	**Case 3**
B Ltd	UK resident	simple non-resident	treaty non-resident
C Ltd	treaty non-resident	treaty non-resident	simple non-resident

Case 1: If B Ltd is UK resident, and C Ltd is treaty non-resident:

(1) C's gain is deemed to accrue to B Ltd; B Ltd may claim DTT relief, as noted above.
(2) A Ltd does not need to claim relief, as
 (a) C's gain is not deemed to accrue to A under s.13(9) and
 (b) apparently C's gain is not deemed to accrue to A under s.13(2) (but if it did, DTT relief would be available.)

Case 2: If B Ltd is simple non-resident and C Ltd is treaty non-resident, C's gain in principle accrues to A. Section 13(9) TCGA provides:

> [a] If a person who is a participator in the company at the time when the chargeable gain accrues to the company is itself a company which
> [i] is not resident in the UK but which

[ii] would be a close company if it were resident in the UK,

[b] [i] *an amount equal* to the amount apportioned under subsection (3) above out of the chargeable gain to the participating company's interest as a participator in the company to which the gain accrues

[ii] shall be further apportioned among the participators in the participating company according to the extent of their respective interests as participators, and

[c] subsection (2) above shall apply to them accordingly in relation to the amounts further apportioned,

[d] and so on through any number of companies.

HMRC accept that A can claim DTT relief. This is so even though s.13(9) refers to "an amount equal to" the gain. The words do not show there is a change in the character of the income (though they do perhaps show some confusion on the point.)

If C Ltd is simple non-resident, but B Ltd is treaty non-resident, C's gain is deemed to accrue to A, but A cannot claim DT relief.

41.11.4 *UK trust participator*

Section 79B TCGA provides:

> (1) This section applies where the trustees of a settlement are participators[31]—
> (a) in a close company, or
> (b) in a company that is not resident in the UK but would be a close company if it were resident in the UK.
> (2) Where this section applies, nothing in any double taxation relief arrangements shall be read as preventing a charge to tax arising by virtue of the attribution to the trustees under s.13, by reason of their participation in the company mentioned in subsection (1) above, of any part of a chargeable gain accruing to a company that is not resident in the UK.

Suppose a trust owns a treaty non-resident company which realises a gain:

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31 Section 79B(1) provides: "For this purpose 'participator' has the same meaning as in section 13".

Trust	*UK resident*
B Ltd	*Treaty non-resident*

DTT relief is disallowed under s.79B(1)(b).

I am unable to see the point of s.79B(1)(a). If the trustees are participators in a *close* company, gains accrue to that company and not to the trustees. I would be grateful if any reader could offer an explanation.

Section 79B(3) TCGA provides:

> Where this section applies and—
> (a) a chargeable gain accrues to a company that is not resident in the UK but would be a close company if it were resident in the UK, and
> (b) all or part of the chargeable gain is treated under section 13(2) as accruing to a close company which is not chargeable to corporation tax in respect of the gain by reason of double taxation arrangements, and
> (c) had the company mentioned in para (b) (and any other relevant[32] company) not been resident in the UK, all or part of the chargeable gain would have been attributed to the trustees by reason of their participation in the company mentioned in subsection (1) above,
>
> section 13(9) shall apply as if the company mentioned in para (b) above (and any other relevant company) were not resident in the UK.

Section 79B(3) addresses the more challenging case where:

(1) a trust owns a holding company ("B Ltd") which is UK resident;
(2) B holds a treaty non-resident subsidiary ("C Ltd"):

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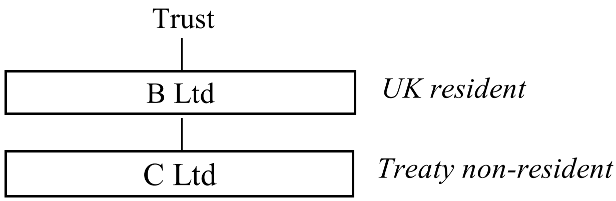
32 Section 79B(4) TCGA provides:
"The references in subsection (3) above to 'any other relevant company' are to any other company which if it were not resident in the UK would be a company in relation to which section 13(9) applied with the result that all or part of the chargeable gain was attributed to the trustees as mentioned in that subsection."



B Ltd is not taxed under s.13 on C's gain as DTT relief applies. In the absence of s.79B(3), the gain apparently cannot be apportioned to the trust under s.13(9) or s.13(2). The trust does not need DTT relief. Section 79B(3) treats B Ltd as non-resident, so that the gain accruing to C can be attributed to the trust under s.13(9).

41.12 Foreign tax credit: s.13 TCGA

SP D23 provides:

> **Non-resident company: TCGA 1992 s 13**
> [1] Where a UK participator in a non-resident company which would be a close company if resident in the UK is chargeable to CGT on a proportion of a capital gain accruing to that company, tax credit relief may be given against UK CGT for the appropriate proportion of any overseas tax payable by the company in the country where it is resident in respect of its gain TCGA 1992 s 277;
> [2] alternatively, under TCGA 1992 s 278, the appropriate proportion of the overseas tax may be deductible in computing the shareholder's gains to the extent that the overseas tax has not qualified for relief under TCGA 1992 s 277.

This relates to two reliefs:

(1) Foreign tax credits
(2) CGT computation deduction

The CG Manual summarises these two reliefs and gives a worked example:

> **57381. Overseas tax payable by NR SP D23**
> The non-resident company may have to pay tax on the gain in its country of residence. UK residents to whom the gain is apportioned will get relief for this tax. The two methods of giving relief are set out in SP

D23.

- Either the UK resident can claim tax credit relief, see CG57382 or
- a proportionate part of the tax can be claimed in computing the apportioned gain, see CG57383.

57382. Tax credit relief

The UK resident can claim tax credit relief under TCGA 1992, s.277. Relief is given on a proportion of the foreign tax equal to the proportion of the total gain attributable to the UK resident. This amount is set-off against the charge to CGT or Corporation Tax on the relevant chargeable gains. See the example at CG57384. If tax credit relief is allowed no deduction under TCGA 1992, s.278 can be allowed in computing the chargeable gain. See CG57383.

57383. Tax deducted in computing gain

If the UK resident does not want to claim tax credit relief, the tax can be deducted in computing the gain, TCGA 1992, s.278. The foreign tax paid does not qualify for indexation allowance. Although it is an allowable deduction in computing the gain it is not a deduction within TCGA 1992, s.38(1)(a) or TCGA 1992, s.38(1)(b). This means it is not relevant allowable expenditure for indexation allowance purposes, see CG17240. In all other respects you compute and apportion the gain in the usual way allowing the foreign tax paid as a deduction. See the example in CG57384. For further guidance on TCGA 1992, s.278 see CG14410+.

57384. Foreign tax paid by a NR company

This example illustrates the differences between allowing any foreign tax paid by the non-resident company as tax credit relief or as a deduction in computing the gain.

Facts

- The non-resident company realises a gain of £20,000 computed under the normal CGT rules.
- It has to pay £5,000 tax on this gain in its country of residence.
- 75 % of the gain is attributable to a UK resident.

CGT treatment

A TCGA 1992, s.13 charge of £20,000 @ 75 % = £15,000 is apportioned to the UK resident. Relief for the tax paid can be claimed in two ways.

- TAX CREDIT RELIEF, SEE CG57382.

Suppose the UK resident is liable to CGT at 40 %. The tax payable would be £6,000. The UK resident can claim tax credit relief on the foreign tax of £5,000 paid by the company in the same proportion as the gain is apportioned. £5,000 @ 75 % = £3,750. The total tax payable by the UK resident becomes £2,250.

- DEDUCTION IN COMPUTING THE GAIN, SEE CG57383.
The foreign tax paid of £5,000 can be deducted in computing the gain. No indexation allowance is due on this deduction. The gain to be apportioned becomes £20,000 –£5,000 = £15,000. The taxpayer's share is £15,000 @ 75 % = £11,250. At a rate of 40 % the tax payable would be £11,250 @ 40 % = £4,500.
In this example you would expect the taxpayer to claim tax credit relief.

41.13 DT reliefs: offshore income gains

This section considers the position before the changes which are proposed from 1 December 2009.

41.13.1 *OIGs accruing directly to treaty-resident individual*

Suppose an individual who is UK resident and treaty-resident outside the UK disposes of offshore funds so that OIGs accrue directly to him.
Article 13(5) OECD Model Convention provides (with immaterial exceptions):

> Gains from the alienation of any property ... shall be taxable only in the Contracting State of which the alienator is a [treaty-resident].

Article 21(1) OECD Model Convention provides:

> Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

It is an interesting question whether the individual claims relief under Art.13 or Art.21. At first sight OIGs are "gains" which arise from the alienation of property, even though not chargeable gains and even though subject to income tax rather than CGT. But OIGs are also "income" if that word is given its normal UK tax meaning. Of course it does not normally matter which of the articles apply, if the treaty has both. But if a particular treaty has an equivalent of art.21 (other income) but no capital gains article, then it is considered that treaty relief is still in principle available.

41.13.2 *s. 13 OIGs: close company treaty-resident outside the UK*

Suppose OIGs accrue to a company which is treaty-resident outside the UK and so are deemed to accrue to a UK resident participator under s.13 TCGA. In principle, DT reliefs apply to OIGs deemed to accrue under OIG s.13 just as they do for chargeable gains deemed to accrue under CGT s.13.[33]

I have considered section 762(5) ICTA which provides:

> If, by virtue of [the OIG s.13 rules], offshore income gains are treated as arising to a person, for the purposes of s.761 as it applies in relation to the offshore income gains treat the person as having made the disposal in question.

For the reason for this provision, see 23.18.4 (Deemed disposal where anti-avoidance provisions apply). This does not disapply treaty relief, either because it has no application for the purposes of the treaty or because (while deeming the participator to be the disponor) it does not say that the non-resident company is not the alienator.

41.13.3 *s. 13 OIGs: participator treaty-resident outside the UK*

In the case of CGT s13 gains, the participator has a difficulty in obtaining relief under a CG article, in that he is not at first sight the "alienator". See 41.11.2 (Treaty non-resident individual holding simple non-resident company). However it is considered that the other income article provides relief, in the case of OIGs. If the capital gains article is in point, it appears that s.762(5) ICTA deems the participator to be the alienator.

41.13.4 *s. 87 OIGs: beneficiary treaty-resident outside the UK*

In the case of CGT s.87 gains, the beneficiary has a difficulty in obtaining relief, in that he is not at first sight the "alienator" and the gain is not "from the alienation of any property". See 41.16.2 (Beneficiary treaty-resident outside the UK). However it is considered that the other income article provides relief, in the case of OIGs. If the capital gains article were

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33 For this terminology, see 23.17 (OIG s.13 charge).

in point, it appears that s.762(5) ICTA deems the beneficiary to be the alienator but the problem remains that the gain is not "from the alienation of any property".

41.14 DT reliefs: s.77 TCGA

Until 2008/09, s.77(1) TCGA provided, so far as relevant:

> *(1) Where in a year of assessment—*
> *(a) chargeable gains accrue to the trustees of a settlement from the disposal of any or all of the settled property,*
> *(b) after making any deduction provided for by section 2(2) in respect of disposals of the settled property there remains an amount on which the trustees would be chargeable to tax for the year in respect of those gains ... , and*
> *(c) at any time during the year the settlor has an interest in the settlement,*
> *[i] the trustees shall not be chargeable to tax in respect of those gains but*
> *[ii] instead chargeable gains of an amount equal to that referred to in para (b) shall be treated as accruing to the settlor in that year.*

DTT relief was overridden by s.83A TCGA:

> ***83A Trustees both resident and non-resident in a year of assessment***
> *(1) This section applies if a chargeable gain accrues to the trustees of a settlement on the disposal by them of an asset in a year of assessment and the trustees—*
> *(a) are within the charge to capital gains tax*[34] *in that year of assessment, but*
> *(b) are non-UK resident at the time of the disposal.*

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34 Section 83A(3) gives this expression a commonsense definition:
"(3) For the purposes of this section the trustees of a settlement are within the charge to capital gains tax in a year of assessment—
(a) if, during any part of that year of assessment, they are resident in the UK and not Treaty non-resident, or
(b) if they are ordinarily resident in the UK during that year of assessment, unless they are Treaty non-resident during that year of assessment."

The expression in (b) was somewhat artificially defined in s.83A(4) TCGA:

> *For the purposes of this section the trustees of a settlement are non-UK resident at a particular time if, at that time,—*
> *(a) they are neither resident nor ordinarily resident in the UK, or*
> *(b) they are resident or ordinarily resident in the UK but are Treaty non-resident.*

If these conditions are satisfied, s.83A(2) TCGA overrode DTT relief:

> *Where this section applies, nothing in any double taxation relief arrangements shall be read as preventing the trustees from being chargeable to capital gains tax (or as preventing a charge to tax arising, whether or not on the trustees) by virtue of the accrual of that gain.*

It was clearly assumed that DTT relief would otherwise apply to s.77 gains, even though under s.77 "chargeable gains *of an amount equal* to" the trustees gains are treated as accruing to the settlor.

41.15 DT reliefs: s.86 TCGA

41.15.1 *Trustees treaty-resident outside the UK*

Assuming the fundamental s.86 conditions are satisfied, s. 86(4) TCGA provides:

> Where this section applies—
> (a) chargeable gains of an amount equal to that referred to in subsection (1)(e) above shall be treated as accruing to the settlor in the year ...

The CG Manual para 38313 provides:

> **Double taxation relief**
> The gain which is chargeable on the settlor is not the same gain as that which accrues to the trustees, but only an amount equivalent to that gain.
> Therefore articles in particular Double Taxation agreements, under

> which chargeable gains from the alienation of particular property are exempt from UK tax, will not operate to exempt the settlor from liability under Schedule 5.

That is, relief does not apply even if the trust is resident in a jurisdiction with standard form DTT CGT relief. This is very doubtful, for the same wording in s.77 is consistent with DTT relief. The Manual continues:

> Where, however, the particular article provides for the allowance, as a credit, of overseas tax payable on gains, that tax can be allowed as a credit. This is because UK tax is computed by reference to the same chargeable gains in respect of which the overseas tax is computed. If there is no Double Taxation agreement, then unilateral relief is available on the same basis.

In some circumstances, s.86(3) TCGA overrides treaty relief.

41.15.2 *Settlor treaty-resident outside the UK*

Suppose the settlor is domestic-law UK resident but treaty resident outside the UK. Can the settlor claim direct relief? The point is the same as for s.13 gains. Art.13(5) OECD Model Convention provides (with immaterial exceptions):

> Gains from the alienation of any property ... shall be taxable only in the Contracting State of which the *alienator* is [treaty-resident].

It appears that the settlor does not qualify for treaty relief because (though treaty non-resident) the settlor is not the alienator. The trustees are the alienator but (on the facts of this example) the trustees are not treaty non-resident. So the terms of art.13(5) are not satisfied. The US treaty is wider and DT exemption applies to those who are treaty-resident in the US: see below. Even under the OECD model, the same result is arguable on the grounds that the gain is treated as accruing to the settlor, he should be deemed to be the alienator; or the word "Alienator" does not require that one must alienate property, only that the gain on the alienation accrues to the person.

41.16 DT reliefs: s.87 TCGA

41.16.1 *Trustees treaty-resident outside UK*

This section considers whether DT reliefs can be available where:

(1) Gains accrue to a trust which is treaty-resident outside the UK.
(2) A UK resident beneficiary receives a benefit so a s.87 deemed gain accrues to him.

The DTT offers no defence to the charge on the beneficiary. The gain accruing to trustees meets the requirements for DTR but the s.87 deemed gain accruing to the beneficiary under s.87 TCGA is not the same gain as the gain accruing to the trustees.

41.16.2 *Beneficiary treaty-resident outside the UK*

Suppose now the beneficiary is UK resident but treaty-resident outside the UK, in a jurisdiction with a DTT with a common form CGT article. Can the beneficiary claim treaty relief directly? Art.13(5) OECD Model Convention provides (with immaterial exceptions):

> Gains from the alienation of any property ... shall be taxable only in the Contracting State of which the alienator is a resident.

It is suggested that the beneficiary cannot claim DTT relief because:
(1) The beneficiary is not the alienator.[35]
(2) The gain is not "from the alienation of any property."

However, a CGT computation deduction is available so foreign tax paid by the trustee is deducted in computing the s.2(2) amount. This is because:

(1) The s.2(2) amount is the amount on which trustees would have been chargeable to tax if UK resident; and
(2) UK resident trustees would qualify for a CGT computation deduction,

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35 See 41.11.2 (Treaty non-resident individual holding simple non-resident company).

which reduces the amount on which trustees would be chargeable to tax.[36]

41.17 USA DTT

Article 1(8) of the USA DTT provides:

> An item of income, profit or gain derived through a person that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a Contracting State to the extent that the item is treated for the purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.

This is not in the OECD Model Treaty but it is in the US Model Income Tax Convention from 1996 and is now standard in US treaties. If both the UK and the USA regard an entity as transparent (eg a partnership) then this provision is not needed, for (say) partnership income would in any event be regarded as income of the partners. The provision is needed for a hybrid entity, ie one which is regarded as transparent in one jurisdiction but not in another. The US Department of the Treasury Technical Explanation of the Convention[37] provides:

> Paragraph 8 addresses special issues presented by fiscally transparent entities such as partnerships and certain estates and trusts. In general, paragraph 8 relates to entities that are not subject to tax at the entity level, as distinct from entities that are subject to tax, but with respect to which tax may be relieved under an integrated system. This paragraph applies to any resident of a Contracting State who is entitled to income derived through an entity that is treated as fiscally transparent under the laws of either Contracting State. Entities falling under this description in the United States include partnerships, common investment trusts under section 584 and grantor trusts. This paragraph also applies to US limited liability companies ("LLCs") that are treated as partnerships for US tax purposes.
>
> Under paragraph 8, an item of income, profit or gain derived by such a fiscally transparent entity will be considered to be derived by a resident of a Contracting State if a resident is treated under the taxation laws of that State as deriving the item of income. For example, if a UK company pays interest to an entity that is treated as fiscally transparent for US tax purposes, the interest will be considered derived by a resident of the US only to the extent that the taxation laws of the

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36 I am grateful to John Dick for this observation.

37 *www.ustreas.gov/offices/tax-policy/library/teus-uk.pdf*

United States treats one or more US residents (whose status as US residents is determined, for this purpose, under US tax law) as deriving the interest for US tax purposes. In the case of a partnership, the persons who are, under US tax laws, treated as partners of the entity would normally be the persons whom the US tax laws would treat as deriving the interest income through the partnership. Also, it follows that persons whom the United States treats as partners but who are not US residents for US tax purposes may not claim a benefit for the interest paid to the entity under the Convention, because they are not residents of the United States for purposes of claiming this treaty benefit. (If, however, the country in which they are treated as resident for tax purposes, as determined under the laws of that country, has an income tax convention with the UK, they may be entitled to claim a benefit under that convention.) In contrast, if, for example, an entity is organized under US laws and is classified as a corporation for US tax purposes, interest paid by a UK company to the US entity will be considered derived by a resident of the United States since the US corporation is treated under US taxation laws as a resident of the United States and as deriving the income.

The same result obtains even if the entity were viewed differently under the tax laws of the UK (e.g., as not fiscally transparent in the first example above where the entity is treated as a partnership for US tax purposes). Similarly, the characterization of the entity in a third country is also irrelevant, even if the entity is organized in that third country. The results follow regardless of whether the entity is disregarded as a separate entity under the laws of one jurisdiction but not the other, such as a single owner entity that is viewed as a branch for US tax purposes and as a corporation for UK tax purposes. These results also obtain regardless of where the entity is organized (i.e., in the United States, in the UK, or, as noted above, in a third country).

For example, income from US sources received by an entity organized under the laws of the United States, which is treated for UK tax purposes as a corporation and is owned by a UK shareholder who is a UK resident for UK tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent. Rather, for purposes of the treaty, the income is treated as derived by the US entity.

These principles also apply to trusts to the extent that they are fiscally transparent in either Contracting State. For example, if X, a resident of the UK, creates a revocable trust in the United States and names persons resident in a third country as the beneficiaries of the trust, X would be treated under US law as the beneficial owner of income derived from the United States. In that case, the trust's income would be regarded as being derived by a resident of the UK only to the extent that the laws of the UK treat X as deriving the income for UK tax purposes by application of the UK "settlor trust" rules.

41.17.1 *US partnerships and LLPs*

HMRC say:

> **How the DTC treats US partnerships and LLCs**
> [HMRC set out Art.1(8) of the DTC and continue:] A transparent concern itself is therefore not given the right to found a claim for relief.

The main reason that a transparent entity does not claim DTT relief is that it is not "liable to tax" in a state which regards it as transparent, and so is not a "resident of a Contracting State".[38]

> Instead, that right is given individually to those 'qualifying persons' defined by the General Definitions Article 3; and as further qualified by the Limitation on Benefits Article 27, who have derived their beneficial entitlement to income, profit or gain through their participation in the transparent concern.[39]

I think the authors means to say that the relief is given to persons who meet (1) the conditions in Art.*4* so as to be "residents of a Contracting State" as defined, and (2) the conditions in Art.*23* so as to be *qualified* persons as defined. HMRC continue with a concession:

> **What this would mean for partners and LLC members**
> Strictly speaking, HMRC Residency should accept claims only from those partners and members who themselves fall to be regarded as 'qualifying persons' in their own right.
> In practice, this would mean as many separate claims for one item of UK-source income paid to a transparent concern such as a partnership or LLC as there are beneficial owners to whom it is then being paid on or distributed.
> HMRC Residency recognises that applying the DTC provisions in such a literal way would be unwelcome to its customers and could possibly hamper the business interests of both countries. It would be a retrograde step in customer service terms, and would not be justified on either an assessment of risk to the UK Exchequer or on compliance grounds. HMRC Residency wants to keep a proper balance between the ease with which US residents should be able to claim relief with the administrative procedures and paperwork that must be employed by the UK Revenue to verify and give effect to such a claim.
> **HMRC Residency's approach to partnerships and LLCs**
> Accordingly, HMRC Residency intends to continue its previous practice of taking claims in the names of both partnerships and LLCs.
> These concerns should use the form US/Company 2002,and should provide (as

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38 See 5.9 (Partnerships).

39 HMRC add: "It will be noted that this is not so very different from the situation that obtained under Article 4(1)(b)(i) of the 'old' 1980 DTC." I am not sure about that, but the point does not now arise.

before) a list of the names and addresses of the partners or members, with details of their respective shares of income. This is covered by the second bullet of the form's own Guidance Note 2.

This form is tailored for use by the majority of those non-individual businesses and concerns which are covered by detailed provisions of the DTC - most notably by the Limitations on Benefit Article 23, which lays down very specific tests for defining the 'qualified persons' who can benefit under the treaty. There is therefore no separate section for transparent concerns such as partnerships or LLCs.

What partnerships and LLCs are asked to do

HMRC Residency ask partnerships and LLCs to complete the US/Company 2002 as follows

* Parts A and B in full
* Part C in full, as appropriate
* Part D if repayment of UK tax is claimed
* Part E if appropriate
* Part F in full, with the general or managing partner/member signing the declaration
* With the additional details as requested in the US-Company 2002 Notes, which is part of the claim form.

Claimants are also free to attach any statement or schedule in support of the claim, as they believe would help explain their circumstances or the basis of the claim.

What HMRC Residency will do

HMRC Residency will consider the replies to all the above, and the information supplied.

Consistent with previous practice, where the facts allow the reasonable conclusion that all beneficial owners of the income for whose shares relief is being claimed are 'qualifying persons' within the meaning of the DTC, then HMRC Residency will process things in the normal way. This will more often than not involve a reference to the tax office for the UK payer, under normal internal liaison arrangements.

If the information given in with the claim form does not allow this conclusion, considering in particular the tests set out in Article 23, HMRC Residency will probably have to contact claimants with further specific questions and requests for information before it can consider finalising processing of things.

HMRC Residency do not want to add to the time taken to resolve matters. Where possible, it will start processing the claim, on a 'without prejudice' basis and pending satisfactory conclusion of any correspondence.

HMRC Residency will be as quick as possible, with due consideration for customers' business needs, and with sympathy and understanding for any compliance difficulties that the process might cause them.

As with any claim, letting HMRC Residency have an advance copy of the form US/Company 2002 (at the time it is submitted to the IRS for certification) may allow it to flag up any points of difficulty at an early stage, and opens up the possibility of anticipating what is needed or might be done before the certified form arrives.

No doubt some high level lobbying has taken place.

41.17.2 The Exchange of Notes

An Exchange of Notes between the Governments of the UK and USA provides:

> *With reference to paragraph 8 of Article 1 (General scope)—*
> [1] it is understood that where an item of income, profit or gain is derived through a person which is a resident of a Contracting State the provisions of the paragraph shall not prevent that Contracting State from taxing the item as the income, profit or gain of that person.

The US Department of the Treasury Technical Explanation of the Convention[40] provides:

> Paragraph 8 is not an exception to the saving clause of paragraph 4.[41] Accordingly, the notes confirm that paragraph 8 does not prevent a Contracting State from taxing an entity that is treated as a resident of that State under its tax law. For example, if a US LLC with UK members elects to be taxed as a corporation for US tax purposes, the United States will tax that LLC on its worldwide income on a net basis, without regard to whether the UK views the LLC as fiscally transparent. The portion of the notes relating to Article 24 (Relief from Double Taxation) provides rules for determining which Contracting State has the primary right to tax and which State must provide a credit in such circumstances.

The Exchange of Notes continues:

> [2] It is further understood that, where, by virtue of the paragraph,
> [a] an item of income, profit or gain is considered by a Contracting State to be derived by a person who is a resident of that Contracting State, and
> [b] the same item is considered by the other Contracting State to be derived by that person or by a person who is a resident of that other

40 *www.ustreas.gov/offices/tax-policy/library/teus-uk.pdf*

41 Art.1(4) US DTT provides: "Notwithstanding any provision of this Convention except paragraph 5 of this Article, a Contracting State may tax its residents (as determined under Article 4 (Residence), and by reason of citizenship may tax its citizens, as if this Convention had not come into effect."

Contracting State,

the paragraph shall not prevent either Contracting State from taxing the item as the income, profit or gain of the person considered by that State to have derived the item of income, profit or gain.

[3] It is further understood that, in applying the paragraph, the UK shall, exceptionally, regard an item of income, profit or gain arising to a person as falling within the paragraph where another person is charged to UK tax in respect of that item of income, profit or gain—

(a) under section 660A or 739, ICTA 1988 [now s.624 ITTOIA & s.720 ITA]; or

(b) under section [77][42] or 86, TCGA 1992.

[4] It is further understood that, in applying the paragraph, a person shall be regarded as fiscally transparent under the laws of the UK in relation to an item of income, profit or gain where a charge is made on another person on that item either—

(a) by virtue of section 13, TCGA 1992; or

(b) because that other person has (or, under [what is now s.464 ITA[43]], is treated as having) an equitable right in possession in a trust.

With reference to Article 24 (Relief from double taxation)—

it is understood that, under paragraph 4 or 8 of Article 1 (General scope), the provisions of the Convention may permit the Contracting State of which a person is a resident (or, in the case of the United States, a citizen), to tax an item of income, profit or gain derived through another person (the entity) which is fiscally transparent under the laws of either Contracting State, and may permit the other Contracting State to tax

(a) the same person;

(b) the entity; or

(c) a third person

with respect to that item. Under such circumstances, the tax paid or accrued by the entity shall be treated as if it were paid or accrued by the first-mentioned person for the purposes of determining the relief from double taxation to be allowed by the State of which that first-mentioned person is a resident (or, in the case of the United States, a citizen), except that, in the case of an item of income from real property to which paragraph 1 of Article 6 (Income from real property) of the Convention applies, or a gain from the alienation of real property to which paragraph 1 of Article 13 (Gains) applies, the tax paid or accrued by the person who is a resident of the Contracting State in which the real property is

42 [Author's note. Section 77 is now repealed.]

43 See 11.15.4 (Scots trusts).

> situated shall be treated as if it were paid or accrued by the person who is a resident of the other Contracting State.
>
> In the case where the same item of income, profit or gain derived through a trust is treated by each Contracting State as derived by different persons resident in either State, and
>
> (a) the person taxed by one State is the settlor or grantor of a trust; and
>
> (b) the person taxed by the other State is a beneficiary of that trust,
>
> the tax paid or accrued by the beneficiary shall be treated as if it were paid or accrued by the settlor or grantor for the purposes of determining the relief from double taxation to be allowed by the State of which that settlor or grantor is a resident (or, in the case of the United States, a citizen), except that, in the case of an item of income from real property to which paragraph 1 of Article 6 (Income from real property) of the Convention applies, or a gain from the alienation of real property to which paragraph 1 of Article 13 (Gains) applies, the tax paid or accrued by the person who is a resident of the Contracting State in which the real property is situated shall be treated as if it were paid or accrued by the person who is a resident of the other Contracting State.
>
> It is further understood that paragraphs 2 and 5 of Article 24 shall apply to such an item of income, profit or gain to the extent necessary to provide relief from double taxation.

41.18 "Subject to tax"

Some treaties provide exemption for income which is "subject to tax". This is not in the OECD Model, but for instance Art.VI (Dividends) of the UK/German treaty provides:

> (1) Dividends paid by a company resident in one of the territories to a resident of the other territory may also be taxed in the former territory. Tax shall not, however, be charged in that former territory at a rate in excess of 15 per cent on the gross amount of such dividends *provided that those dividends are subject to tax in the other territory* or ...

Similarly, Art.VII(1) (Interest and royalties) and Art.XV (other income).

So far as the issue concerns foreign tax it would ultimately be decided by foreign tax authorities and courts, but the HMRC view may well represent an international consensus. So it is relevant to note that INT Manual para 162020 provides:

> **162020. 'Subject to tax'** [August 2006]
> The terms of some agreements provide that a resident of the UK will be entitled to exemption or relief from the foreign tax on certain types of income only if he is subject to tax on that income in the UK.
> A person is regarded as subject to tax if, for example ...
> e) the remittance basis applies: he is subject to tax only on the sums remitted.

Similarly, in the context of the lower-paid employee exemption, HMRC say:

> **Is it necessary to have paid tax in another country on the overseas income?**
> No. Although 'subject to a foreign tax' might in some circumstances mean that the individual is required to pay tax on the income abroad, this is not a necessary requirement to take advantage of this exemption. As a result of overseas personal allowances, or provisions akin to such allowances, or of a tax rate of 0 per cent, there might be no requirement to pay tax on part or all of the income. However, such income would still be considered to be 'subject to a foreign tax' in the context of this exemption.[44]

44 Residence and Domicile: Amendments to the new rules introduced in Finance Bill 2009 accessible *www.hmrc.gov.uk/cnr/faq-resdom.htm*.

CHAPTER FORTY TWO

EU LAW DEFENCE TO ANTI-AVOIDANCE PROVISIONS

42.1 EU law defence – Introduction

This chapter considers whether the following anti-avoidance provisions are consistent with EU law:[1]

(1) s.13 TCGA
(2) s.86 TCGA
(3) s.720 ITA

If not, the taxpayer may have a defence to the provisions which I call "**the EU defence**".

A full discussion would require a book to itself, but it would not be easy to complete because the case law is developing very quickly.

In this chapter I refer to a non-resident company established in another Member State as a "**MS company**".

The primacy of EU law over UK domicile law hardly needs to be stated, but to begin at the beginning: s.2 European Communities Act 1972 provides:

> All such rights, powers, liabilities, obligations and restrictions from time to time created or arising by or under the Treaties, and all such remedies and procedures from time to time provided for by or under the Treaties, as in accordance with the Treaties are without further enactment to be given legal effect or used in the UK shall be recognised and available in law, and be enforced, allowed and followed accordingly;

1 See too 6.7 (EU restriction on exit taxes).

In *Steve Thoburn v Sunderland City Council*, Laws LJ stated as "fundamental propositions":

> (1) All the specific rights and obligations which EU law creates are by the 1972 Act incorporated into our domestic law and rank supreme: that is, anything in our substantive law inconsistent with any of these rights and obligations is abrogated or must be modified to avoid the inconsistency. This is true even where the inconsistent municipal provision is contained in primary legislation.
> (2) The 1972 Act is a constitutional statute: that is, it cannot be impliedly repealed.[2]

42.2 Freedom of establishment

Article 43 EC establishes a freedom of establishment ("**FoE**"):

> [1][a] Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited.
> [b] Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.
> [2] Freedom of establishment shall include the right
> [a] to take up and pursue activities as self-employed persons and
> [b] to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 48,
> under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the chapter relating to capital.

The key point here is the right to set up subsidiaries and undertakings (including companies): Arts 43[1][b] and 43[2][b].

Article 48 makes it clear that the right extends to companies as well as to individuals:

> [1] Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or

2 [2003] QB 151 at [69].

> principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.

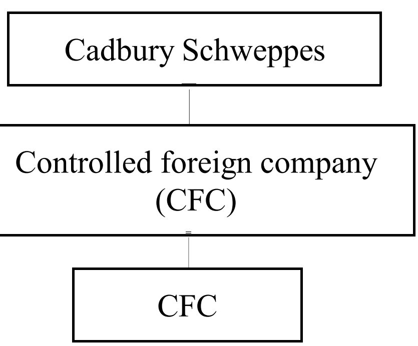
Article 48[2] defines "companies or firms" but for present purposes little turns on the definition.[3]

Article 45 EC provides a limited exception for public policy:

> The provisions of this Chapter and measures taken in pursuance thereof shall not prejudice the applicability of provisions laid down by law, regulation or administrative action providing for special treatment for foreign nationals on grounds of public policy, public security or public health.

42.3 Restriction on freedom of establishment

Cadbury Schweppes v IRC [2006] STC 1908 concerned this corporate structure:



It is not self-evident that the CFC legislation restricted the parent company's FoE, but the ECJ held that it did:

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3 "'Companies or firms' means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making."

Thus a charity, for instance, has no FoE and could not rely on art. 43 EC as a defence to a charge under s.13 TCGA (unless it could count as profit-making). In this chapter it is assumed that the taxpayer is an individual or a profit-making company.

> 44 Where the resident company has incorporated a CFC in a Member State in which it is subject to a lower level of taxation within the meaning of the legislation on CFCs, the profits made by such a controlled company are, pursuant to that legislation, attributed to the resident company, which is taxed on those profits. Where, on the other hand, the controlled company has been incorporated and taxed
> [1] in the UK or
> [2] in a State in which it is not subject to a lower level of taxation within the meaning of that legislation,
> the latter is not applicable and, under the UK legislation on corporation tax, the resident company is not, in such circumstances, taxed on the profits of the controlled company.
> 45 That difference in treatment creates a tax disadvantage for the resident company to which the legislation on CFCs is applicable. Even taking into account ... the fact ... that such a resident company does not pay, on the profits of a CFC within the scope of application of that legislation, more tax than that which would have been payable on those profits if they had been made by a subsidiary established in the UK, the fact remains that under such legislation the resident company is taxed on profits of another legal person. That is not the case for a resident company with
> [1] a subsidiary taxed in the UK or
> [2] a subsidiary established outside that Member State which is not subject to a lower level of taxation.
> 46 ... the separate tax treatment under the legislation on CFCs and the resulting disadvantage for resident companies which have a subsidiary subject, in another Member State, to a lower level of taxation are such as to hinder the exercise of freedom of establishment by such companies, dissuading them from establishing, acquiring or maintaining a subsidiary in a Member State in which the latter is subject to such a level of taxation. They therefore constitute a restriction on freedom of establishment within the meaning of Articles 43 EC and 48 EC.

The CFC rules only applied to companies in some member states, namely, those subject to a lower level of taxation (as defined). Because of this selective operation the CFC rules clearly restricted FoE, since given the choice in siting a subsidiary in (1) a MS with a lower level of taxation or (2) a MS with a higher level of taxation (but less than the UK) one would in principle prefer to chose the latter. But the point made at 44[1] and 45[1] shows that the CFC rules would restrict freedom of establishment if they applied to every MS, regardless of the level of taxation just because they did not apply in the UK. At first sight that seems very surprising. But the income of the CFC is subject to foreign tax as well as UK tax. Although UK tax allows a credit for the foreign tax, the burden of dealing with two tax systems is a real one.[4] This may have been a real deterrent against a UK parent establishing a CFC in any other MS.

42.4 Abuse and justification

42.4.1 *Abuse and justification compared*

The ECJ considered separately (1) whether there was an abuse of EC law and (2) whether the CFC legislation was justified. I would have thought that the two questions were linked, for provisions to prevent abuse would necessarily be justified.

Perhaps the distinction is:

(1) in cases of abuse, the EU defence fails (even if UK provisions are unlawful in EU law);
(2) in the absence of abuse, the EU defence succeeds (assuming the UK's provisions are contrary to EU law).

42.4.2 *Abuse*

Cadbury Schweppes dealt with abuse quite shortly:

> 35 It is true that nationals of a Member State cannot attempt, under cover of the rights created by the Treaty, improperly to circumvent their national legislation. They must not improperly or fraudulently take advantage of provisions of Community law (Case 115/78 *Knoors* [1979] ECR 399, para 25; Case C-61/89 *Bouchoucha* [1990] ECR I-3551, para 14; and Case C-212/97 *Centros* [1999] ECR I-1459, para 24).

Here of course everything depends on the meaning of the elastic term "improperly". ("Fraudulently" adds nothing since (whatever it means) anything which is fraudulent must also be improper.)

4 DTT relief was (unfairly) denied: see 41.6.2 (*Bricom*).

> 37 As to freedom of establishment, the Court has already held that the fact that the company was established in a Member State for the purpose of benefiting from more favourable legislation does not in itself suffice to constitute abuse of that freedom (see, to that effect, Centros, para 27, and Case C-167/01 *Inspire Art* [2003] ECR I-10155, para 96).
> 38 ... it follows that the fact that in this case *Cadbury Schweppes* decided to establish [its CFCs] in [Ireland] for the avowed purpose of benefiting from the favourable tax regime which that establishment enjoys does not in itself constitute abuse.

We do not know what abuse is, but we know what it is not, and if this is not abuse then a subsidiary company is never an abuse.

42.4.3 *Justification*

The ECJ subsequently considered whether there was a justification for the CFC legislation:

> 55 It follows that, in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent
> [1] conduct involving the creation of wholly artificial arrangements which do not reflect economic reality,
> [2] with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.

There are two requirements for justification: [1] is a conduct requirement and [2] is an intention requirement. Both must be present but the conduct requirement is the more important. What is it?

> ... objective circumstances showing that, despite formal observance of the conditions laid down by Community law, the objective pursued by freedom of establishment, as set out in paras 54 and 55 of this judgment, has not been achieved (see, to that effect, Case C-110/99 *Emsland-Stärke* [2000] ECR I-11569, paras 52 and 53, and Case C-255/02 *Halifax and Others* [2006] ECR I-0000, paras 74 and 75).

What is the conduct requirement?

> 65 In those circumstances, in order for the legislation on CFCs to comply with Community law, the taxation provided for by that

> legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality.

What is economic reality?

> 66 That incorporation must correspond with an actual establishment intended to carry on genuine economic activities in the host Member State, as is apparent from the case-law recalled in paras 52 to 54 of this judgment.

The expression "genuine economic activities" does not take us much further.

> 67 ... that finding must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment.
> 68 If checking those factors leads to the finding that the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement. That could be so in particular in the case of a "letterbox" or "front2 subsidiary (see Case C-341/04 *Eurofood* IFSC [2006] ECR I-0000, paras 34 and 35).

The metaphors of "letterbox" and "front" and the epithet "fictitious" are conclusions rather than indications or useful tests of what is "economic reality".

> 69 On the other hand, as pointed out by the Advocate General in point 103 of his Opinion, the fact that the activities which correspond to the profits of the CFC could just as well have been carried out by a company established in the territory of the Member State in which the resident company is established does not warrant the conclusion that there is a wholly artificial arrangement.

The use of the words "genuine", "reality" and "artificial" is normally a sign of intellectual desperation.

My conclusion is that what constitutes "genuine economic activities" is still at present a fairly open question.[5] The answer should become clearer when the *Cadbury Schweppes* litigation is complete.

42.5 Freedom to provide services

Article 49 EC provides:

> Within the framework of the provisions set out below, restrictions on freedom to provide services within the Community shall be prohibited in respect of nationals of Member States who are established in a State of the Community other than that of the person for whom the services are intended.

In *Cadbury Schweppes* the Advocate General considered and dismissed arguments based on this:

> 34 The applicants submit that the provisions of the Treaty on freedom to provide services also apply in this case. They claim that the legislation at issue makes the supply of financial services by [the CFCs] to their UK resident parent company more difficult. ...
> 35 I am not convinced by the applicants' argument. These proceedings concern the compatibility with Community law of legislation of a Member State which attributes to a resident parent company the profits

5 For HMRC views see "Taxation of the foreign profits of companies: a discussion document" (June 2007) accessible *www.hm-treasury.gov.uk/consult_foreign_profits.htm*:

> "In Cadbury Schweppes, the ECJ confirmed that there is a legitimate role for CFC rules under the Treaty, so long as the rules do not tax the profits of genuine economic activities in overseas subsidiaries.
> The Government considers that, in making this judgment, the Court intended to draw a meaningful distinction between profits from a genuine commercial activity and profits that have been artificially divorced from the activity that creates them. So CFC rules should not be protectionist: but at the same time they may permit the fair allocation of taxing rights between Member States, so respecting the Treaty.
> Commentators who have criticised the changes the Government has made in Finance Bill 07 claim that in the light of Cadbury Schweppes only highly artificial transfers may be targeted by CFC rules. Subsequent rulings from the Court (e.g. on the thin capitalisation case) support the Government's wider reading – but full certainty on this point is unlikely to be achieved in the short term."

See Weber "Tax Avoidance & the EU Treaty Freedoms", Kluwer, 2005, p. 9.

> of its subsidiary established in another Member State when that subsidiary is subject to a much lower level of taxation in that State. The nature of the activity carried on by [the CFCs] is not specifically referred to by that legislation. ...
> 36. Admittedly, if the legislation at issue has the result that a resident company is dissuaded from establishing a subsidiary in another Member State, it also has the result that the supply of services by such a subsidiary out of that Member State is prevented. However, that latter restriction is a consequence of the hindrance to establishment. In the present case, it is exactly the freedom to establish a subsidiary in that Member State which is at the core of the proceedings. I do not therefore see the relevance of reliance on the rules on freedom to provide services as well. In any event, I do not believe that examination of the legislation at issue in the light of that freedom, in addition to freedom of establishment, can change the result of my analysis.

42.5.1 *Generalising from CFCs to other anti-avoidance rules*

The CFC legislation attributes income of a non-resident to a UK resident. The attribution of income or gains of a non-resident to a UK resident is also a feature of all the anti-avoidance rules discussed in this chapter.

42.6 Section 13 TCGA

Section 13 TCGA is a restriction on FoE on an individual who owns 100% of a non-resident company (the non-resident company is established in a MS).

In fact (unlike the CFC case) the restriction on FoE before 2007/08 is self-evident: if I set up a foreign company within s.13 I will not only pay tax but the amount of tax is more than would have been the same than if the company had been UK resident (because the individual paid 40%, and the company only 30%).

From 2008/09 the restriction on FoE is less than self-evident, since:

(1) if I set up a UK company, the company pays tax on its chargeable gains at 30%;
(2) if I set up a foreign company, I pay tax on its gains at 18%.

Far from being a restriction on FoE, the rule is one which encourages FoE!

But if one focuses on the individual alone and not on the structure as a whole, there is a FoE restriction.

What if the individual owns less than 100% of the MS company? FoE confers only a right to "set up and manage".

What if the company is owned by a trust? The right to FoE is a right of nationals of a MS (extended to companies and firms). What is the nationality of a trust?

There can be no question of justification because the CFC legislation has a motive exemption,[6] but s.13 TCGA has none.

42.7 Section 720 ITA

Section 720 ITA restricts FoE where:

(1) the transferor is a national of a MS.
(2) the person abroad is a MS company.

Is the restriction justified? Only if one can construe the motive defence in a manner compatible with the guidelines of *Cadbury Schweppes*. We will know more when that litigation is final.

If the person abroad is a trust in another MS, s.720 is incompatible only if the trust is an undertaking within the meaning of art. 43 EC. But in such cases s.624 ITTOIA will usually apply, and as that applies to UK as well as non-resident trusts, it does not restrict freedom of establishment.

42.8 Section 86 TCGA

42.8.1 *Position from 2008/09*

Section 86 TCGA constitutes a restriction on FoE where the settlor is a MS national, provided the trust is an undertaking within the meaning of art. 43 EC.[7]

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6 Which might at a pinch meet the conduction requirement; see *Vodafone (No. 2) v HMRC*.

7 As to whether a trust is an "undertaking" see Weber, "Tax Avoidance & the EU Treaty Freedoms", Kluwer, 2005, p.27.

42.8.2 *Position before 2008/09*

Section 86 TCGA does not constitute a FoE restriction when the settlor has an interest in the trust within the meaning of s.77 TCGA, for in such a case the provisions apply wherever the trust is situate.

Section 86 TCGA does constitute a FoE restriction where:

(1) the settlor is a MS national;
(2) the settlor has an interest in the trust within the meaning of s.86 TCGA but not within the meaning of s.77 TCGA;
(3) the trust is an "undertaking".

CHAPTER FORTY THREE

DEEMED DOMICILE FOR IHT

43.1 Three classes of domicile for inheritance tax

The general concept of domicile is discussed at 2.1 (Domicile). In principle, an individual must have either a UK domicile or a foreign domicile; there is no middle way. But a foreign domiciliary could often secure effective exemption from inheritance tax and live almost indefinitely in the UK without acquiring a UK domicile of choice. The inheritance tax code therefore seeks to identify foreign domiciliaries who have close UK connections and provides that for most (but not all) purposes, such individuals are treated as if they were UK domiciliaries. The IHTA does not supply suitable terminology. In this book I refer to three classes of individuals as:

(1) actual UK domiciliaries;
(2) deemed UK domiciliaries (or deemed domiciliaries); and
(3) actual foreign domiciliaries.

43.2 Deemed UK domicile

Section 267(1) IHTA provides:

> A person not domiciled in the UK at any time (in this section referred to as "the relevant time") shall be treated for the purposes of this Act as domiciled in the UK (and not elsewhere) at the relevant time if—
> (a) he was domiciled in the UK within the three years immediately preceding the relevant time, or

(b) he was resident in the UK in not less than seventeen of the twenty years of assessment ending with the year of assessment in which the relevant time falls.

I refer to condition (a) as **"the 3 year domicile rule"** and condition (b) as **"the 17-year residence rule"**.

43.2.1 *The 3-year domicile rule*

The first rule concerns the person who is actually UK domiciled and who loses his UK domicile. Such a person is deemed domiciled in the UK for three years from the date of his change of domicile. Unlike rule (b) this period is not related to years of assessment.

43.2.2 *The 17-year residence rule: time of acquisition of deemed domicile*

The second rule concerns the person who is not actually UK domiciled but who becomes resident here. Once he has been resident in the UK for 17 out of the last 20 years of assessment he becomes deemed domiciled here under the 17-year residence rule. In the discussion below I abbreviate "years of assessment" to "tax years".

Note that the immigrant foreign domiciliary does not need to be present in the UK for 17 full years. In an extreme case, fifteen years and two days may suffice. An individual who arrives in the UK on 5 April 1983 may arguably be resident in the UK in the tax year 1982/83. (Although this seems surprising, this would be the HMRC view, if the individual came to the UK to live here permanently or intending to stay for three years or more.) If he was still here on 7 April 1998 he may be resident in the tax year 1998/99. The 17-year residence condition would then be satisfied.

43.2.3 *The 17-year residence rule: time of loss of deemed domicile*

Once an individual is UK resident continuously for a block of 17 tax years, the individual must reach his fourth year of non-residence before ceasing to be deemed domiciled under the 17-year residence rule. The matter is best illustrated by a table:

Year	Resident Years	**20 years ending year where transfer made in:**				
		1999/00	2000/01	2001/02	2002/03	2003/04
1980/81	*Not relevant*	1				
1981/82	*Not relevant*	2	1			
1982/83	*Not relevant*	3	2	1		
1983/84	Resident 1	4	3	2	1	
1984/85	Resident 2	5	4	3	2	1
1985/86	Resident 3	6	5	4	3	2
1986/87	Resident 4	7	6	5	4	3
1987/88	Resident 5	8	7	6	5	4
1988/89	Resident 6	9	8	7	6	5
1989/90	Resident 7	10	9	8	7	6
1990/91	Resident 8	11	10	9	8	7
1991/92	Resident 9	12	11	10	9	8
1992/93	Resident 10	13	12	11	10	9
1993/94	Resident 11	14	13	12	11	10
1994/95	Resident 12	15	14	13	12	11
1995/96	Resident 13	16	15	14	13	12
1996/97	Resident 14	17	16	15	14	13
1997/98	Resident 15	18	17	16	15	14
1998/99	Resident 16	19	18	17	16	15
1999/00	Resident 17	**20**	19	18	17	16
2000/01	Non-resident 1		**20**	19	18	17
2001/02	Non-resident 2			**20**	19	18
2002/03	Non-resident 3				**20**	19
2003/04	Non-resident 4					**20**
Deemed domicile in 2003/04		**Yes**	**Yes**	**Yes**	**Yes**	**No**

Suppose an individual is resident in the UK throughout the block of 17 tax years from 1983/84 to 1999/00. We have to identify a relevant time. We then have to identify the tax year in which the relevant time falls. The table considers transfers of value in each of the 5 years 1999/00 to 2003/04.

We then have to identify "the twenty years of assessment ending with the year of assessment in which the relevant time falls". For each of the years 1999/00 to 2003/04 those 20 years include the 17-year block (shaded in the table), so the individual is deemed UK domiciled.

43.2.4 *Comparison of the two rules*

It is easy to envisage cases where a person is caught by one rule and not by the other.

For instance, consider a person who has always been UK resident and domiciled and who ceases to be UK domiciled on 1 August 1998. He ceases to be caught by the 3-year domicile rule on 1 August 2001. However, as he was UK resident in 1998/99, he will still be deemed UK domiciled under the 17-year residence rule until 6 April 2002 (the start of the year 2002/03).

Again, a UK domiciled person may reside outside the UK for twenty years and then acquire an actual foreign domicile. Such a person is not affected by the 17-year residence rule. But three more years must pass before he ceases to be UK domiciled under the 3 year domicile rule.

43.3 Deemed domiciliary leaving the UK

Suppose:

(1) A person who is not actually UK domiciled becomes deemed UK domiciled, having spent 17 tax years resident here.
(2) He then ceases to be resident in the UK. In the fourth tax year after departure, he ceases to satisfy the 17-year rule.

Is the person still treated as domiciled here for three years under the 3-year domicile rule? In other words, does the deemed domicile rule in (a) apply to a person who was only a deemed domiciliary under (b)? The answer is, no. It is considered that (a) and (b) are independent rules dealing with separate circumstances. If that were wrong, then the following absurdity arises. Suppose T, non-resident for many years, ceases to be UK domiciled. In year 1 he becomes deemed domiciled. In year 4 he ceases to be deemed domiciled. HMRC could argue that since he was (deemed) domiciled in year 3, he must wait three more years before he can cease to be deemed domiciled. Then, of course, three years later he is still deemed domiciled. He can never throw off the deemed domicile. This shows that "domicile" in s.267(1)(a) means actual domicile and not deemed domicile. The word should have the same meaning throughout the section.[1]

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1 This is consistent with *Russell v IRC* [1988] STC 195.

43.4 Domicile of child of a deemed domiciliary

A child usually acquires the domicile of his father at the time of his birth as a domicile of origin; and if the father's domicile changes while the child is under 16, the child acquires the father's new domicile as a domicile of dependency. Does one have regard to the deemed domicile rule for this purpose? Suppose:

(1) F is actually foreign domiciled but deemed UK domiciled when a child is born; or
(2) F is not deemed UK domiciled when the child is born but becomes deemed UK domiciled while the child is under 16.

It is suggested that the deemed domicile rule does not affect the child's domicile: in each case the child is not deemed UK domiciled (until the child has spent 17 yeas resident in the UK. Applying s.267, it is only the person actually resident in the UK who is deemed UK domiciled. The deemed domicile of the father does not affect the domicile of the child. Of course, the question will not often arise, since the domicile of children and young persons only rarely needs to be ascertained.

43.5 Meaning of "residence" for 17-year residence rule

Section 267(4) IHTA provides:

> For the purposes of this section the question whether a person was resident in the UK in any year of assessment shall be determined as for the purposes of income tax.

Thus in this context "residence" has its normal income tax meaning, whatever that is.

For years prior to 1993/94 s.267(4) IHTA provided:

> For the purposes of this section the question whether a person was resident in the UK in any year of assessment shall be determined as for the purposes of income tax *without regard to any dwelling house available in the UK for his use.*

This excluded the (supposed) available accommodation rule but it went further and disregarded available accommodation for all residence purposes.[2] This remains significant when determining residence for the years up to 1992/93 which will feature as part of the 17-year calculation until 2010. IHT Manual para 13024 provides:

> We follow any residency rulings made by CNR with one qualification. For the tax years before 6 April 1993, someone was considered to be resident in the UK if they set foot here during the year and had a dwelling house in the UK, which was available for their use. However, availability of a dwelling house was ignored for the purposes of our 17/20 rule (Section 267(4) IHTA 1984). In the absence of any information, you should assume that residency rulings for Income Tax made prior to 93/94 were **not** made on the basis of this rule alone.

It is considered that the split year concession (ESC A11) does not apply, so years of arrival and departure are counted as full years of residence.

43.6 Visiting forces

Section 155 IHTA provides (in short) that visiting forces do not become deemed domiciled even if they reside 17 or more years in the UK (but in practice I expect that hardly ever happens).[3]

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2 See 3.6 (Accommodation in the UK).

3 There is also a relief for the property of visiting forces: see 44.7 (Visiting forces). Unfortunately there is an ambiguity in the section:

> "**155 Visiting forces, etc**
>
> (1) Section 6(4) above applies to—
>
> (a) the emoluments paid by the Government of any designated country to a member of a visiting force of that country, not being a British citizen, a British Dependent Territories citizen, a British National (Overseas) or a British Overseas citizen, and
>
> (b) any tangible movable property the presence of which in the United Kingdom is due solely to the presence in the United Kingdom of such a person while serving as a member of the force.
>
> (2) A period during which any such member of a visiting force as is referred to in subsection (1) above is in the United Kingdom by reason solely of his being such a member shall not be treated for the purposes of this Act as a period of residence in the United Kingdom or as creating a change of his residence or domicile."

It is considered that the relief does not apply to members of visiting forces who are British citizens (etc) even though on a literal reading one might say that such

43.7 When deemed domicile does not matter: exempt gilts and DTT

There are two situations where a deemed domicile rule does not apply:

(1) exempt gilts and qualifying certificates of Islanders (discussed here);
(2) pre-1975 double tax treaties.[4]

Section 267(2) IHTA provides:

> Subsection (1) above shall not apply for the purposes of section 6(2) or (3) or 48(4) above ...

That is, the deemed domicile rules do not apply for the purposes of the exemptions conferring excluded property status on exempt gilts[5] and qualifying certificates of Islanders.[6]

The reason is historical. The concept of deemed domicile was introduced with CTT in 1974. At that time gilts had been issued free from taxation (including Estate Duty) if the owner was not (actually) UK domiciled. The deemed domicile rule could not have been applied to those gilts. All that the drafter needed to do was to disapply the deemed domicile rule to exempt gilts in issue at the time of the introduction of CTT (now IHT). It was not necessary to disapply the deemed domicile rule to gilts issued later. But that is the rule. Presumably the intention was to avoid having two classes of exempt gilts governed by different rules; or to encourage foreigners to continue to invest in exempt gilts issued after 1975.

No doubt the same reasoning applied to qualifying certificates of Islanders.

This rule gives some scope for IHT planning by individuals who are deemed UK domiciled but who qualify for these exemptions (i.e. non-UK ordinarily residents and Islanders).

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persons are “referred to” in s.155(1).

4 See 50.1 (IHT pre-1975 double tax treaties).

5 See 44.4 (Non-settled property: exempt gilts) and 44.11 (Trusts: exempt gilts).

6 See 44.6 (Individual domiciled in Channel Islands or Isle of Man).

43.8 Pre-1974 transitional rules

Section 267(3) contains five transitional rules:

> Para (a) of subsection (1) above shall not apply in relation to a person who (apart from this section) has not been domiciled in the UK at any time since 9th December 1974 ...

This disapplies the 3-year domicile rule only. It would only apply in a relatively rare case of someone who was actually UK domiciled and ceased to be so before 9 December 1974.

> and para (b) of that subsection shall not apply in relation to a person who has not been resident there at any time since that date ...

This disapplies the 17-year residence rule only. It would only apply to someone who had been UK resident for 17-years and ceased to be so before 9 December 1974.

> and that subsection shall be disregarded—
> (a) in determining whether settled property which became comprised in the settlement on or before that date is excluded property,

This applies to pre-9 December 1974 settlements.

> that subsection shall be disregarded— ...
> (b) in determining the settlor's domicile for the purposes of section 65(8) above in relation to settled property which became comprised in the settlement on or before that date, and
> (c) in determining for the purpose of section 65(8) above whether the condition in section 82(3) above is satisfied in relation to such settled property.

This applies to the exemption for exempt gilts.

43.9 Tax planning for the deemed domiciliary

(1) The emigrant deemed domiciliary

An individual who has emigrated from the UK (i.e. acquired a foreign domicile of choice) remains an "emigrant" deemed domiciliary for three years. His inheritance tax planning, if in good health, is simple; he should refrain from making any gifts until he has ceased to be deemed UK domiciled. If he wishes to make substantial gifts before then, he might consider purchasing exempt gilts or some other property which qualifies as excluded property. Deathbed planning would be the same. In addition he might consider taking out a loan to purchase excluded property: see 47.6 (Individual borrows and acquires excluded property).

(2) The immigrant deemed domiciliary

The immigrant deemed domiciliary is the foreign domiciliary who has resided for a long period in the UK and became deemed UK domiciled. His scope for planning is greatly restricted; he should really take proper steps before the statutory deadline when his deemed domicile arises.

If the individual is actually domiciled in the Isle of Man or in the Channel Islands then he has some scope for acquiring excluded property in the form of exempt saving certificates.[7] Otherwise it may be possible to cease to be UK resident for the necessary period of three tax years so that the deemed domicile rules cease to apply.

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7 See 44.6 (Individual domiciled in Channel Islands or Isle of Man).

CHAPTER FORTY FOUR

EXCLUDED PROPERTY FOR IHT

44.1 Excluded property – Introduction

"Excluded property" is broadly[1] outside the scope of inheritance tax. There are nine classes of excluded property:

(1) Non-settled property:[2]
 (a) foreign situate property;
 (b) AUTs and OEICs;
 (c) exempt gilts.
(2) Settled property:
 (a) foreign situate property;
 (b) AUTs and OEICs;
 (c) exempt gilts.
(3) Qualifying certificates of Islanders (Channel Islands/Isle of Man domiciliaries).
(4) Certain property of visiting forces.
(5) Reversionary interests in settled property.

Thus with an economy of language the exemptions for excluded property are used to serve many purposes:

(1) A territorial exemption.
(2) Limiting the scope of IHT in other ways:

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1 See 44.16 (Occasions where excluded property is relevant for IHT).

2 A note on terminology. I use the term "non-settled property" to describe property which is not comprised in a settlement for IHT purposes. The term used in the IHT Manual is "unsettled property".

(a) in order to encourage UK investment by foreigners (exempt gilts, UK funds);
(b) to fit the scheme of the Act or avoid double taxation (relief for reversionary property, visiting forces, etc).

This chapter sets out the definitions of excluded property. It also considers works of art and foreign bank accounts, which (though not excluded property) qualify for some similar exemptions. The implications for tax planning are discussed at the end of this chapter.

44.2 Non-settled property: foreign situate property

Section 6(1) IHTA provides:

> Property situated outside the UK is excluded property if the person beneficially entitled to it is an individual domiciled outside the UK.

Excluded property status depends on the domicile of the individual at the time a transfer of value is made. Likewise, excluded property status depends on the location of assets at that time only. It is irrelevant that the assets may previously have been situate in the UK. If a foreign domiciled individual transfers his property out of the UK the moment before he dies, or the moment before he makes a gift of the property, he obtains the full benefit of excluded property status: see *Kwok Chi Leung Karl v Commissioner of Estate Duty* [1988] STC 728. On the situs of assets, see ? (Concepts of situs).

44.3 Non-settled property: authorised unit trusts and OEICs

Section 6(1A) IHTA provides:

> A holding in an authorised unit trust[3] and a share in an open-ended

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3 Defined in s.272 IHTA:
"'authorised unit trust' means a scheme which is a unit trust scheme for the purposes of the Income Tax Acts (see section 1007 of the ITA 2007) and in the case of which an order under section 243 of the Financial Services and Markets Act 2000 is in force."

> investment company[4] is excluded property if the person beneficially entitled to it is an individual domiciled outside the UK.

AUTs and OEICs will generally be UK situate assets. I refer to them together as "UK funds". These are excluded property for all IHT purposes.

44.4 Non-settled property: exempt gilts

The next category of excluded property consists of certain British government securities (known as FOTRA securities,[5] and popularly called "exempt gilts"). Exempt gilts are UK situate assets. Section 6(2) IHTA provides:

> Where securities have been issued by the Treasury subject to a condition authorised by section 22 of the F(No.2)A 1931 (or section 47 of the F(No. 2)A 1915) for exemption from taxation so long as the securities are in the beneficial ownership of persons of a description specified in the condition, the securities are excluded property if they are in the beneficial ownership of such a person.

Exempt gilts usually have one of the following names:
–Conversion Stock
–Exchequer Stock
–Index-Linked Treasury Stock
–Treasury Loan
–Treasury Stock
–War Loan

Products issued by National Savings and Investments are not exempt gilts.

44.4.1 *Conditions for exemption*

The conditions for exemption are not stated in the IHTA. The conditions

4 Defined in s.272 IHTA:
"'open-ended investment company' means an open-ended investment company within the meaning given by section 236 of the Financial Services and Markets Act 2000 which is incorporated in the UK." This definition is considered in ? (Definition of OEIC).

5 "Free of Tax to Residents Abroad".

must be:

(1) authorised by the relevant statutory provision; and
(2) set out in the prospectus for the particular gilts concerned.

The statutory authority is in the following terms. (I only set out the provisions so far as relevant for inheritance tax and omit the income tax exemption.) Section 22(1) F(No.2)A 1931 provides:

> Any securities issued by the Treasury under any Act may be issued with the condition that …
> (b) so long as the securities are in the beneficial ownership of persons who are neither domiciled nor ordinarily resident in the UK, neither the capital thereof nor the interest thereon shall be liable to any taxation present or future.

Section 60 FA 1940 provides:

> The power of the Treasury under s.22 F(No.2)A 1931 to issue securities with the condition as to exemption from taxation specified in that section shall extend to the issuing of securities with that condition so modified, whether as to the extent of the exemption or the cases in which the exemption is to operate, as the Treasury may specify in the terms of the issue.

Section 154(1) FA 1996 provides:

> The modifications which, under s.60 of the FA 1940, may be made for the purposes of any issue of securities to the conditions about tax exemption specified in s.22 of the F(No.2)A 1931 shall include a modification by virtue of which the tax exemption contained in any condition of the issue applies, as respects capital, irrespective of where the person with the beneficial ownership of the securities is domiciled.

It will be seen that the statutory provisions since 1940 do not specify the condition for exemption. So the details must be found in the prospectus for each gilt concerned.[6]

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6 Prospectuses can be found on *www.dmo.gov.uk/rpt_parameters.aspx?rptCode=D8E&page=Prospectuses*

Before 6 April 1998 some gilts were issued without FOTRA conditions. These have now been given the benefit of FOTRA conditions by s.161 FA 1998:

> (1) Subject to the following provisions of this section, any gilt-edged security[7] issued before 6 April 1998 without FOTRA conditions shall be treated in relation to times on or after that date as if—
> (a) it were a security issued with the post-1996 Act conditions; and
> (b) those conditions had been authorised in relation to the issue of that security by virtue of s.22 of the F(No. 2)A 1931….
> (5) In this section "the post-1996 Act conditions" means the FOTRA conditions with which 7.25% Treasury Stock 2007 was first issued by virtue of s.22 of the F(No. 2)A 1931.[8] ...
> (7) This section does not apply to any 3½% War Loan 1952 Or After which was issued with a condition authorised by virtue of s.47 of the F(No. 2)A 1915.

There are, therefore, two classes of exempt gilts for IHT purposes, with different conditions attached:

(1) Gilts where the condition requires the individual to be domiciled[9] and ordinarily resident outside the UK. These include:
   (a) 3½% War Loan 1952 Or After, issued under s.47 F(No.2)A 1915.
   (b) Gilts issued under s.22 F(No.2)A 1931, where this was the condition set out in the prospectus.
(2) Where the condition requires the beneficial owner to be ordinarily resident outside the UK but domicile is irrelevant. This applies to:
   (a) Gilts issued before 6 April 1998 without FOTRA conditions; these now have the benefit of "post-1996 Act conditions" under s.161 FA 1998.
   (b) Gilts issued after 1996, where the prospectus set out this condition. I understand that all gilts issued after 29 April 1996

7 "Gilt-edged securities" has the CGT definition: see s.161(6) FA 1998.

8 This was one of the first gilts issued in 1996/97. The condition provides: "the Stock will be exempt from all UK taxation, present or future, so long as it is shown that the Stock is in the beneficial ownership of persons who are not ordinarily resident in the UK".

9 Deemed domicile is irrelevant for this purpose: see ? (When deemed domicile does not matter: exempt gilts and DTT).

contain this condition.

IHT Manual 27243 sets out a list of gilts where the requirement is that the beneficial owner is ordinarily resident outside the UK (domicile irrelevant). Para 27244 sets out a list of the gilts where the requirement is that the beneficial owner is neither domiciled nor ordinarily resident in the UK. However, it would be wise to check the prospectus in each case.

44.4.2 *Beneficial ownership*

The gilts must be in the "beneficial ownership" of the individual. There have been many cases discussing "beneficial ownership" in the context of company groups, and the reader who wishes to research this area further should refer to the discussion on group relief in corporation tax and SD textbooks.[10] Unfortunately the case law is in disarray and a number of contradicting dicta can be found. But two propositions seem reasonably clear. Gilts remain in the beneficial ownership of an individual even if he has granted a mortgage or charge.[11] Gilts are not in the beneficial ownership of an individual if he has entered into a contract to sell them–even a conditional contract.[12]

Gilts remain in the beneficial ownership of an individual even if he has granted put and call options, according to *Sainsbury v O'Connor* 64 TC 208.

Ownership correctly understood consists of a bundle of rights over property; or if you prefer, ownership has a number of incidents. In the case of gilts the bundle (or incidents) consists of the right to dividends, redemption and rights of disposal. Clearly, one can make some dent in the usual array of rights or incidents and still remain an owner. This explains why one remains beneficial owner after granting a charge or licence. But the courts have raised unnecessary problems by regarding these rights not as separately existing, but as merged into one general concept of

10 The expression "beneficial ownership" is used in DTTs, but there it has an international fiscal law, non-technical sense. See "The Origins of Concepts and Expressions used in the OECD Model" [2006] BTR at p.747. It is considered that discussion of the expression in a DTT context is no assistance to ascertain the meaning in the present context, or generally in a UK tax statute.

11 *English Sewing Cotton v IRC* [1947] 1 All ER 679.

12 *Wood Preservation v Prior* 45 TC 112.

ownership and, further, insisting that this right of ownership must (with limited exceptions) be regarded as vested in one person or another. This causes artificial results when property is subject to a contract of sale and it is said that ownership must be vested in either the vendor or purchaser. The true analysis should be that ownership rights are split between them. Neither should be regarded as "the" beneficial owner.[13] Likewise for property subject to an option. On this analysis, *Wood Preservation* was rightly decided but for the wrong reasons, and *Sainsbury* was wrongly decided. But however unconvincing the reasoning, the law on this point is settled below the House of Lords.

44.4.3 *Beneficial ownership in Scotland*

The IHT Manual at 04031 discusses the expression "beneficially entitled", in a passage which sheds a little light on beneficial ownership:

> The use of the words 'beneficially entitled' means broadly that the estate includes only property
> - to which a person is entitled, or
> - in which they have an interest for their own benefit.
>
> In England, Wales and Northern Ireland this includes property which a person owns either legally or beneficially (IHTM04441).

So far, the text is unexceptionable. The discussion then turns to Scotland:

> In Scotland, the term 'ownership' does not necessarily equate to beneficial entitlement, for example where the land that is being transferred is subject to missives of sale [or][14] there is an unrecorded disposition. This is because of the Scottish system of unitary ownership. Any case where the question is in point should be referred to TG (IHTM01081) for advice.

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13 Likewise the courts have come to reject the dogma that "where ownership is vested in a trustee, equitable ownership must necessarily be vested in someone else because it is an essential requirement of a trust that it confers upon individuals a complex of beneficial legal relations which may be called 'ownership'". See *CPT Custodian Pty Ltd v Commissioner of State Revenue* [2005] 2 ALR 196 at [25] accessible *www.austlii.org*. Of course, the context in which the expression "beneficial owner" is used should always be considered.

14 The original reads "of". The emendation to "or" makes sense, though it might be that some text is missing here.

The text raises the interesting suggestion that the position in Scots law is not the same as in English law. I would be grateful to any Scots reader who could direct me to relevant authority.[15] The passage concludes:

> A person is not beneficially entitled to property held
> - purely in a fiduciary capacity (for example as a trustee)
> - in a representative capacity (for example as an executor or a trustee in bankruptcy), or
> - by way of security (for example as a mortgagee prior to foreclosure).
>
> ...

This is clearly right.

44.4.4 *Registration*

IHTM04294 [September 2008] provides:

> If a government security is a FOTRA gilt (IHTM04291) you will have to consider who is beneficially entitled (IHTM04031) to that security to work out whether it is excluded property for IHT purposes..
> If a worthwhile amount is at stake[16] you should investigate the possibility of a last-minute purchase. Except where the available information (e.g. inclusion of sufficient income/interest) reasonably rules out that possibility, you should seek specific confirmation that the securities concerned were in fact registered in the transferor's, or the trustee's, name(s) at the date of the relevant transfer.
> (This text has been withheld because of exemptions in the Freedom of Information Act 2000)

Before October 2005, the IHT Manual stated that relief only applied if the gilts were registered in the name of the individual (or if the securities were settled, in the name of the trustees). This view has rightly been abandoned. The most that can be said is that if the gilts are not registered in the name of the individual, further proof may be needed to show that

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15 A Barr and S Eden, *Inheritance Tax in Scotland* (Butterworths), or F McDonald and P Pagan, *Inheritance Tax in Scotland: Tax Annual* (Tottel) may help here.

16 Understandably, the HMRC view on what is "worthwhile" in this context is not in the public domain.

the individual actually is the beneficial owner.

In practice, register the gilts in the name of the individual or the trustees to avoid possible dispute. Perhaps the withheld text instructs Inspectors how to identify false claims for relief.

44.4.5 *Interest and tax repayment on exempt gilts*

The IHT Manual provides:

> **27260 Exclusion of interest on exempt securities**
> The exclusion for exempt securities can also apply to certain payments etc of interest on the securities. Payments that qualify for the exclusion are:
> [1] warrants or coupons for interest already received but not encashed at the date of the relevant chargeable event
> [2] apportionment of interest due up to, but receivable after, the date of the chargeable event
> [3] in the case of a trust, any interest payments already encashed but held – at the date of the chargeable event – by the trustees pending distribution in the administration of the trust. This is so even if no separate moneys can be identified as relating directly to interest on exempt securities.
> The **exclusion for interest does not apply** to any warrants or coupons already encashed, or payments of interest already received, by the beneficiary in his lifetime, in connection with any chargeable event occurring after the encashment or the receipt. This is so whether he is the absolute owner of the exempt securities or a beneficiary under a trust.

This is correct, but point [3] seems generous. The Manual continues:

> **27261 Exclusion of repayment of IT on exempt securities**
> Repayment of income tax relating to interest on exempt securities also falls within the exclusion for such securities:
> - if an existing warrant for repayment remains uncashed at the date of the relevant chargeable event
> - in the case of a trust, if the proceeds of an encashed warrant are held – at the date of the chargeable event – by the trustees pending distribution in the administration of the trust or
> - if the repayment due up to the date of the chargeable event is receivable after the date.

> A repayment encashed – before a chargeable event – by the person beneficially entitled to the repayment is not eligible for the exclusion on that event.

Before 1998 interest was generally paid subject to deduction of tax. Since then interest is paid without deduction of tax (unless the owner asks for tax to be deducted) so this point will not arise.

44.4.6 *Practical use of exempt gilts*

The exemption is useful for individuals who are:

(1) UK domiciled (or deemed domiciled);
(2) not ordinarily resident in the UK (so they can satisfy the conditions for exemption).

44.5 UK funds *v* foreign funds

As far as tax is concerned, which is better for the foreign domiciliary: UK funds or foreign funds?

(1) A UK resident foreign domiciled individual will prefer a foreign fund to a UK one, so that income and gains from the fund will be taxed on the remittance basis.[17] Likewise a trust with a foreign domiciled UK resident settlor will prefer a foreign fund to a UK one, if the settlor has an interest, or if the transfer of asset rules may apply, as UK source income from the fund may be taxed under those sections where foreign source income in principle will not.
(2) A non-resident non-domiciled individual will not mind (for IHT, CGT or IT) whether he purchases a UK or a foreign fund. However, taxation at fund level is another matter, and the additional burden on UK funds, particularly SDRT, has recently encouraged fund managers to set up new funds offshore.[18]

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17 If the individual plans to remit income but not gains from the fund, it may be better to have a UK fund. But that is a special case.

18 See "Taxation and the Competitiveness of UK Funds" (October 2006) accessible *www.investmentUK.org/press/2006/jointkpmg-imataxreport.pdf*. The report also notes that the uncertainty and instability of the UK tax regime is regarded as making

Thus the IHT exemption for UK funds represents a pragmatic decision by the Government, but, like so much in the tax system, falls short of joined-up thinking.[19]

44.6 Individual domiciled in Channel Islands or Isle of Man

Section 6(3) IHTA provides:

> Where the person beneficially entitled to the rights conferred by any of the following, namely—
> (a) war savings certificates;
> (b) national savings certificates (including Ulster savings certificates);
> (c) premium savings bonds;
> (d) deposits with the National Savings Bank or with a trustee savings bank;
> (e) a certified SAYE savings arrangement within the meaning of section 703(1) ITTOIA;
> is domiciled in the Channel Islands or the Isle of Man, the rights are excluded property.

In the following discussion:

(1) "**Qualifying certificates**" are investments within (a) to (e).
(2) "**Islanders**" are persons domiciled in the Channel Islands or the Isle of Man.

The deemed domicile rule does not apply for the purposes of this section: see s.267(2) IHTA.

The IHT Manual para 27270 correctly states:

> Other points to note are:
> [1] the exclusion applies not only to securities etc owned by a domiciled Islander absolutely but also to any settled securities in which he has a beneficial interest in possession[20]
> [2] the exclusion does not extend to settled securities in which there is no interest in possession, i.e. which are held on discretionary trusts

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the UK an unsuitable location.

19 See 1.1 (Policy issues in foreign domiciliary taxation).

20 [Author's note] From 2006 this will now only apply to an estate IP.

[3] the relevant domicile is that of the transferor (and not the transferee) of the securities, at the time of the transfer

Points [2] and [3] are obvious but point [1] is important.

The exemption could be particularly useful for an individual who is:

(1) domiciled in the Channel Islands or the Isle of Man, and
(2) deemed UK domiciled (so in principle within the scope of IHT), and
(3) ordinarily resident in the UK (so the exempt gilts exemption is not available).

The exemption dates back to 1931[21] and was presumably an attempt to market the certificates to Islanders, who would otherwise not find them an attractive choice. It seems surprising that the exemption is limited to Islanders; no doubt there were reasons.

44.7 Visiting forces

A fifth category of excluded property is also mentioned only for completeness. This concerns emoluments and tangible movable property of members of visiting forces and their civilian staff (elaborately defined), other than four classes of British citizens.[22]

44.8 Trusts: foreign situate property

Section 48(3) IHTA provides:

> Where property comprised in a settlement is situated outside the UK—
> (a) the property (but not a reversionary interest in the property) is excluded property unless the settlor was domiciled in the UK at the time the settlement was made ...

This is the main category of settled excluded property, roughly corresponding to the main category of non-settled excluded property. Three important consequences arise from the definition.

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21 Section 41 FA 1931.

22 For details see s.155 IHTA. There is also a relief under the deemed domicile rules. See ? (Visiting forces).

First, the resident and domicile status of the beneficiaries is completely irrelevant for this purpose. The residence of the trustees is equally irrelevant.

Secondly, excluded property status depends on the domicile of the settlor at the time the settlement was made. A later change of domicile is ignored.[23] Contrast the IT and CGT position. The identity of the settlor is therefore crucial: see ? (IHT definition of settlor).

Thirdly, the location of the assets comprised in the settlement matters only at the moment a charge arises; provided the assets are then situated abroad, it is irrelevant that they may previously have been situated in the UK. So trustees could transfer the settled property out of the UK the moment before the death of a life tenant, or the occasion of a ten-year charge, and obtain the full benefit of excluded property status: see *Kwok Chi Leung Karl v Commissioner of Estate Duty* [1988] STC 728.

HMRC accept this. IHT Manual para 4274 rightly provides:

> The expression 'property comprised in a settlement' in Section 48(3) IHTA 1984 means the items of property (IHTM04030) held in the settlement (IHTM16000) at the time of the chargeable event that you are considering. In determining the locality (IHTM27071) of any particular property, therefore, you should consider the property in its current form and not its previous history.
>
> *Example*
>
> S, when domiciled in Germany, settles some German realty and some securities then situated in the UK on X for life with remainder to Y. On X's death –the life interest comes to an end and the settled fund consists of
>
> a. a villa in Spain, or
> b. land in the UK, or
> c. a house in Spain and some English securities.
>
> With a., the villa is excluded property even though it partly represents the proceeds of what was previously UK property (the securities). The land in b. is not excluded property although it is partly derived from the German realty. In c., the house is excluded property but the securities are not.

23 See 44.13 (Initial interest of settlor or spouse) for an exception where the settlor or his spouse has an initial interest in possession in the settled property.

44.9 Trusts: authorised unit trusts and OEICs

Section 48(3A) IHTA provides:

> Where property comprised in a settlement is a holding in an authorised unit trust or a share in an open-ended investment company—
> (a) the property (but not a reversionary interest in the property) is excluded property unless the settlor was domiciled in the UK at the time the settlement was made, and
> (b) section 6(1A) above applies to a reversionary interest in the property but does not otherwise apply in relation to the property;[24]
> but this subsection is subject to subsection (3B) below.

There is a difficulty if a discretionary trust holds UK situate property which is invested in a UK fund. Since relevant property becomes excluded property, there is in principle an exit charge under s.65 IHTA. Section 65(7) IHTA normally provides an exemption if a trust acquires excluded property:

> Tax shall not be charged under this section by reason only that property comprised in a settlement ceases to be situated in the UK and thereby becomes excluded property by virtue of section 48(3)(a) above.

Taken literally, this does not apply if UK property is used to acquire a UK fund! But this is a clear oversight, and it is suggested that under modern principles of construction the exemption should be construed to include exemption on the purchase of a UK fund. If this view is wrong, then there would have been many exit charges when the current rules took effect in 2003, because (formerly non-exempt) AUTs and OEICs suddenly became excluded property; this was clearly not the intention of Parliament.

44.10 Purchased equitable interests

Section 48(3) and (3A) IHTA both provide:

> but this subsection is subject to subsection (3B) below. ...

24 See 44.10 (Purchased equitable interests).

Section 48(3B) IHTA is an anti-avoidance provision which applies to two categories of settled excluded property: foreign situate property and UK funds. It provides:

> Property is not excluded property by virtue of subsection (3) or (3A) above if—
> (a) a person is, or has been, beneficially entitled to an interest in possession in the property at any time,
> (b) the person is, or was, at that time an individual domiciled in the UK, and
> (c) the entitlement arose directly or indirectly as a result of a disposition made on or after 5th December 2005 for a consideration in money or money's worth.

EN FB 2006 explains:

> 8. ... By purchasing interests in existing trusts originally settled by a person domiciled outside the UK, UK-domiciled individuals have increasingly exploited this exemption to convert their wealth into IHT-free form.
> 9. This clause is aimed at blocking such avoidance by providing that property is not excluded property by virtue of section 48(3) or section 48(3A) IHTA if, at any time, a person domiciled in the UK has had an interest in possession in it, and their interest arose from a disposition for a consideration in money or money's worth. This applies whoever paid the money, and if the interest was acquired indirectly (for example, under a will or by intestacy) or has been passed on to someone else.

Section 48(3C) IHTA expands on this:

> For the purposes of subsection (3B) above—
> (a) it is immaterial whether the consideration was given by the person or by anyone else, and
> (b) the cases in which an entitlement arose indirectly as a result of a disposition include any case where the entitlement arose under a will or the law relating to intestacy.

Section 48(3C)(a) confirms (what would have been clear) that the provision can apply if an interest is purchased by A and then given by A to B. I am unable to see the point of s.48(3C)(b).

44.11 Trusts: exempt gilts

Exempt gilts held by trustees may be excluded property. Under this exemption the domicile of the settlor is irrelevant; one must look at the ordinary residence of the relevant beneficiary or beneficiaries and, if appropriate, their domicile.

44.11.1 *Estate IP trust*

Section 48(4) IHTA provides:

> Where securities issued by the Treasury subject to a condition of the kind mentioned in subsection (2) of section 6 above are comprised in a settlement, that subsection shall not apply to them; but the securities are excluded property if—
> (a) a person of a description specified in the condition in question is entitled to a qualifying interest in possession in them.

Qualifying IP is defined in s.59(1) IHTA:

> (1) In this Chapter "qualifying interest in possession" means—
> (a) an interest in possession—
> (i) to which an individual is beneficially entitled, and
> (ii) which, if the individual became beneficially entitled to the interest in possession on or after 22nd March 2006, is an immediate post-death interest, a disabled person's interest or a transitional serial interest, or
> (b) an interest in possession to which, where subsection (2) below applies, a company is beneficially entitled.[25]

That is, a qualifying IP is what this book describes as an estate IP. The 2006 reforms have (inadvertently?) greatly restricted the scope of the exemption for exempt gilts in settlements.

44.11.2 *Other trusts*

Section 48(4) IHTA provides:

25 The position for companies entitled to IPs is not considered here.

Where securities issued by the Treasury subject to a condition of the kind mentioned in subsection (2) of section 6 above are comprised in a settlement, that subsection shall not apply to them; but the securities are excluded property if—

...

(b) no qualifying interest in possession subsists in them but it is shown that all known persons

[i] for whose benefit the settled property or income from it has been or might be applied, or

[ii] who are or might become beneficially entitled to an interest in possession in it,

are persons of a description specified in the condition in question.

The IHT Manual correctly states:

27247 Discretionary trusts and exempt securities: introduction
Where, immediately before the transfer concerned, exempt securities are settled property held on discretionary trusts (i.e. no qualifying interest in possession subsists in them) the securities will be excluded from the IHT charge on the transfer if it is shown that all known (IHTM27248) persons for whose benefit any of the settled property (or income from it) has been, or might be applied satisfy the conditions specified by the securities (IHTM27241). The same conditions must also be satisfied in regard to any person who is, or might become, entitled to an interest in possession in any of the settled property.
27248 - Unknown persons [June 2006]
The legislation refers to "known persons". Accordingly, when considering the question of domicile and ordinary residence you should disregard the possibility that some (currently) unknown person (e.g. an unborn child or future spouse/civil partner of an existing beneficiary) might become a beneficiary in the future.
27249 - UK charities
In the case of *Von Ernst and Cie S.A. v IRC* [1980] 1 WLR 468 the Court ruled **that any payment or potential payment** from the settled property to an incorporated UK charity – to be used by the charity for its charitable purposes – would not be an application for the "benefit" of the charity. Accordingly you should not deny the exclusion for exempt securities merely because a UK charity (whether incorporated or not) has received or might receive any of the settled property or income from it.

44.12 Estate IP trust

44.12.1 *The Question*

As we have seen, there are two sets of definitions of excluded property:

(1) Section 6 IHTA defines four categories of excluded property for non-settled property to which a person is beneficially entitled.
(2) Section 48 IHTA defines three corresponding categories of excluded property for trust property.

Property is either settled or not, so at first sight the definitions appear to be mutually exclusive. However, a settlement under which a beneficiary has a recognised interest in possession raises a doubt. Property held in a settlement with an estate IP is certainly settled property (so *prima facie* the s.48 rules apply). However, s.49(1) IHTA provides (for an estate IP):

> A person beneficially entitled to an interest in possession in settled property shall be treated for the purposes of this Act as beneficially entitled to the property in which the interest subsists.

Since the person is treated as beneficially entitled, should the s.6 IHTA rules apply to settled property?

44.12.2 *Foreign situate property in IP trust*

The answer is provided by s.48(3)(b):

> Where property comprised in a settlement is situated outside the UK—
> ...
> (b) section 6(1) above applies to a reversionary interest in the property but does not otherwise apply in relation to the property.

Thus for foreign situate property and exempt gilts, the s.48 definition overrides the s.6 definition. The operation of these rules can be illustrated by two examples:

(1) Suppose a foreign domiciled beneficiary has an estate IP in a settlement made by a UK domiciled settlor. The trust property is

situated outside the UK.

The trust property is not excluded property as it does not meet the requirements of s.45(3)(a). It does not meet the requirements of s.6(1) but s.48(3)(b) disapplies s.6(1).

(2) Suppose the reverse situation – a UK domiciled beneficiary of a settlement created by a foreign domiciled settlor. The trust property is again situated outside the UK.

The tax position is now reversed. The trust property would not be excluded property under s.6(1) but it does qualify under s.48(3)(a). Section 48(3)(b) disapplies s.6(1) but that is irrelevant: the trust property is excluded property.

44.12.3 *Exempt gilts in IP trust*

Section 48(4) IHTA provides:

> Where securities issued by the Treasury subject to a condition of the kind mentioned in subsection (2) of section 6 above are comprised in a settlement, that subsection shall not apply to them; ...

This is not strictly necessary because s.6(2) is consistent with s.48(4)(a).

44.12.4 *Qualifying certificates in IP trust*

Qualifying certificates of an individual domiciled in the Channel Islands or the Isle of Man ("**an Islander**") are excluded property.[26] If an Islander is entitled to an estate IP in qualifying certificates, the certificates are not excluded property under s.48(3) or s.48(4). But it is considered that the property does qualify as excluded property under s.6(3) since the individual is to be treated as if he were beneficially entitled. In this case there is no express provision that s.48 overrides s.6. Section 48 and s.6 do not contradict each other; rather they offer two alternative routes to attain excluded property status. Such settled property is therefore excluded property. HMRC agree.

26 See 44.6 (Individual domiciled in Channel Islands or Isle of Man).

44.12.5 *AUTs and OEICs in estate IP trust*

Section 48 contains no provision to disapply s.6(1A) IHTA. It is therefore considered that if the life tenant is not UK domiciled, UK funds in a trust are exempt property under s.6(1A) (by virtue of s.49(1) IHTA). It does not matter whether the settlor was domiciled in the UK at the time the settlement was made.[27]

A Revenue-minded court might reject this on the ground that Parliament could not have intended the result; but it is not absurd to imagine that Parliament did intend to favour UK funds, so the provision should be given its natural meaning.

44.13 Initial interest of settlor or spouse

44.13.1 *The s.80 fictions*

Special rules apply where the settlor or spouse have an estate interest in possession in a trust when it is made ("**an initial IP**"). The basic rule is set out in s.80(1) IHTA:

> Where a settlor or his spouse or civil partner is beneficially entitled to an interest in possession in property immediately after it becomes comprised in the settlement,
> [a] the property shall for the purposes of this Chapter be treated as not having become comprised in the settlement on that occasion;
> [b] but when the property or any part of it becomes held on trusts under which neither of those persons is beneficially entitled to an interest in possession, the property or part shall for those purposes be treated as
> [i] becoming comprised in a separate settlement
> [ii] made by that one of them who ceased (or last ceased) to be beneficially entitled to an interest in possession in it.

Thus where the settlor or spouse has an initial IP, s.80 imposes three fictions ("**the s.80 fictions**"):

27 Though if the settlor was foreign domiciled when the settlement was made, the UK funds would be excluded property by virtue of s.48(3A) and there is no need to rely on s.6(1A).

(1) Property which is actually in one settlement ("the actual settlement") will be treated as being comprised in a separate settlement ("the notional settlement").
(2) The person who is treated as the settlor of the notional settlement may be the spouse, i.e. different from the real settlor of the actual settlement.
(3) The time at which trust property is treated as becoming comprised in the notional settlement is when the settlor/spouse IP ceases, which is different from the time that property actually became comprised in the actual settlement.[28]

44.13.2 *Trusts before 1974 and after 2006*

Section 80(3) IHTA provides:

> This section shall not apply if the occasion first referred to in subsection (1) above occurred before 27 March 1974.

"The occasion first mentioned in subsection (1)" is the date that the property becomes comprised in the actual settlement, i.e. the date that the settlement is made. So:

(1) Section 80 does not apply to property settled before 27 March 1974.
(2) Section 80 can apply to property settled between 27 March 1974 and 22 March 2006.

The position from 22 March 2006 is governed by s.80(4):

> Where the occasion first referred to in subsection (1) above occurs on or after 22 March 2006, this section applies—
> (a) as though for "an interest in possession" in each place where that appears in subsection (1) above there were substituted "a postponing interest", and
> (b) as though, for the purposes of that subsection, each of the following were a "postponing interest"—

28 This fiction does not apply for the purposes of the ten-year anniversary date, which is fixed by the date of the actual settlement: see s.61(2) IHTA 1984. I cannot see the reason for that rule.

(i) an immediate post-death interest;
(ii) a disabled person's interest.

Section 80 can apply to trusts made from 22 March 2006 only if the trust confers an IPDI (which only applies to will trusts) or a disabled person's interest (which will be rare).

44.13.3 *Spouse with initial IP: excluded property rule*

Suppose:

(1) In Year 1, H creates a trust under which W has an initial IP.
(2) In Year 2, W dies (so her IP comes to an end). H does not become entitled to an IP at the time that W dies.

In this example H is the settlor of the actual trust and Year 1 is the date of commencement of the actual trust. However, applying the s.80 fictions, the property is treated as comprised in a notional trust, which is treated as made in Year 2 and W is treated as the settlor.

If that were all, it would follow that the trust property could be treated as excluded property if W was foreign domiciled at the time of her death in Year 2. The domicile of H would be irrelevant. This would benefit the taxpayer if (for instance) H was UK domiciled and W was not, and could sometimes be used for tax avoidance.

Therefore where s.80 applies, s.82 IHTA imposes a further condition relating to excluded property. This provides:

> **Excluded property**
> (1) For the purposes of this Chapter ... property to which section 80 ... applies shall not be taken to be excluded property by virtue of section 48(3)(a) above unless the condition in subsection (3) below is satisfied (in addition to the conditions in section 48(3) that the property is situated outside the UK and that the settlor was not domiciled there when the settlement was made).
> ...
> (3) The condition referred to in subsection (1) ... is—
> (a) in the case of property to which section 80 above applies, that the person who is the settlor in relation to the settlement first mentioned in that section ...
> was not domiciled in the UK when that settlement was made.

The "settlement first mentioned" in s.80 is the actual settlement made by H. (The notional settlement treated as made by W must be the second settlement mentioned in s.80.)

In relation to foreign situate trust property, s.82 prevents the s.80 fiction from benefiting the taxpayer. The fiction may however benefit HMRC. Where:

(1) H is the settlor,
(2) W has an initial IP, and subsequently
(3) the settled property is held on trusts where neither H nor W has an interest in possession,[29]

it is necessary to look at the domicile of H at the time when the actual settlement was actually made *and* at the domicile of W at the time her interest in possession came to an end in order to determine whether foreign situate trust property (in the notional settlement) is excluded property. Both must be domiciled out of the UK (at the right time) in order for foreign situate property to qualify securely for excluded property status.

44.13.4 *Settlor with initial IP: excluded property rule*

In practice it is rare for the settlor's spouse to have an initial IP but it is common for the settlor to have an initial IP. Suppose first that:

(1) Year 1: H has an initial IP; and
(2) Year 2: that IP comes to an end (without W becoming entitled to an IP).

In this example H is the settlor of the actual trust and Year 1 is the date of commencement of the actual trust. However, applying the s.80 fictions, the property is treated as comprised in a notional trust, which is treated as made in Year 2 though H is still treated as the settlor.

If that were all, it would follow that the trust property could be treated as excluded property if H was foreign domiciled in Year 2. The domicile of

29 Whether an estate IP or not. This is anomalous, but the drafter of the 2006 rules did not think through the consequences for s.80.

H at the time the trust was made would be irrelevant. This could not be used for tax avoidance, but s.82 IHTA nonetheless imposes its further condition relating to excluded property. It is necessary to look at the domicile of H at the time when the actual settlement was actually made *and* at the time his interest in possession came to an end in order to determine whether foreign situate trust property (in the notional settlement) is excluded property. H must be domiciled out of the UK at both times in order for foreign situate property to qualify securely for excluded property status.
Suppose:

(1) In Year 1, H creates a trust under which H has an estate IP.
(2) In Year 2, H dies and W becomes entitled to an IP.
(3) In year 3, W's interest comes to an end (H not at that time becoming entitled to an IP).

In this example H is the settlor of the actual trust and Year 1 is the date of commencement of the actual trust. However, applying the s.80 fictions, the property is treated as comprised in a notional trust, which is treated as made in Year 3 and W is treated as the settlor.

If that were all, it would follow that the trust property could be treated as excluded property if W was foreign domiciled at the time of her death in Year 3. The domicile of H would be irrelevant. Once again, s.82 IHTA imposes a further condition relating to excluded property. In relation to foreign situate trust property, s.82 prevents the s.80 fictions from benefiting the taxpayer. It may however benefit HMRC. It is necessary to look at the domicile of H at the time when the actual settlement was actually made *and* at the domicile of W at the time her interest in possession came to an end in order to determine whether foreign situate trust property (in the notional settlement) is excluded property. Both must be domiciled out of the UK (at the right time) in order for foreign situate property to qualify for excluded property status.

44.13.5 *Planning for partly excluded property trust*

I use the term "partly excluded property trust" to refer to a trust where:

(1) the trust property in the actual settlement is excluded property on ordinary principles; but

(2) it is not excluded property in the notional settlement under s.80/82 rules.

The s.80/82 rules apply only for the purposes of "this chapter": the standard trust regime. They have no wider application. So foreign property of a partly excluded property trust:

(1) is not excluded property for the purposes of the standard trust regime; but
(2) is excluded property for all other IHT purposes (e.g. GWR and the estate IP trust regime).

Before 2006, s.80 did not much matter as a partly excluded property trust could remain IP in form throughout its life. So in practice it qualified as excluded property. Now it cannot do so. So the tax position of these trusts has been seriously affected as an accidental result of the 2006 reforms.

44.13.6 *Avoiding s.80/82 problems: trusts made on or after 22 March 2006*

No difficulty arises for lifetime trusts from 22 March 2006, unless the trust confers a disabled person's interest (which will be rare).

Section 80 still poses a trap for will trusts, where the testator is not UK domiciled and the spouse is UK domiciled. One needs to avoid an IPDI.

A simple solution is to arrange that the will trust is discretionary at the outset, i.e. the widow does not have an initial interest in possession. A two-year discretionary period will in principle be needed to avoid s.144 IHTA. This is easy if the property given to the trust is not UK situate.

44.13.7 *Avoiding s.80/82 problems: trusts made before 22 March 2006*

In cases where an existing trust conferred an initial IP on the settlor/spouse, it would be desirable to revoke the IP before the settlor becomes deemed UK domiciled. It does not matter that the settlor/spouse may have an initial IP provided that when it comes to an end[30] the life tenant is not UK domiciled or deemed domiciled.

30 Not being followed by another IP for the settlor/spouse.

44.13.8 *Postponing s.80/82 problems by TSI*

A partly excluded property trust should retain an estate IP for as long as possible. In practice it would often be good planning to create a transitional serial interest ("TSI") to extend this period. The trust falls within the standard IHT trust regime on the later of the times when:

(1) a TSI comes to an end (assuming there is no estate IP);
(2) the IP of the settlor/spouse comes to an end.

This opportunity for tax planning closed on 5 October 2008.

44.13.9 *Avoiding s.80/82 problems by exempt gilts or UK funds*

Section 80 provides that property shall not be taken to be excluded property *by virtue of s. 48(3)* IHTA.[31] So it prevents foreign situate property from being excluded property. It does not apply to exempt gilts and AUTs.

44.13.10 *Commentary*

What is the purpose of the three s.80 fictions? Dymond explains:

> The [standard IHT trust regime] would not work well where the settlor or his spouse has the first interest in possession under a settlement commencing after 26 March 1974. In such a case there will be no chargeable transfer when the settlement was made and so no occasion to value the settled property for CGT or IHT at that time. If a charge arose nearly 10 years later, it might be difficult to ascertain the value at the commencement of the settlement, as required by section 68(5)(a) IHTA, because important evidence might have been lost or destroyed. It might also not be easy to ascertain the settlor's cumulative total at that time as required by section 68(4)(b) IHTA. The same difficulty with the settlor's cumulative total might occur at the time of the 10 year charge, because of section 66(5)(a).[32]

31 I am grateful to Chris Jarman for pointing this out.
32 *Dymond's Capital Taxes*, para 19.700.

Section 80 solves this valuation problem but the reader may agree with the author that even before 2006 the cure was worse than the disease. (This does explain why the s.80 fictions only apply for the purposes of the standard IHT trust regime.)

Since 2006 the operation of the rules is bizarre, but (as is generally the case with bizarre law) careful planning can mitigate much of the unfairness.

44.14 Settlor adds property to trust after change of domicile

Suppose:

(1) a settlor creates a trust when not UK domiciled; and
(2) the same settlor[33] adds funds to the trust later when UK domiciled.

Can the added property be excluded property? The IHT Manual para 4272 provides:

> **4272. When the settlement was made** [October 2007]
> The legislation refers to the settlor's (IHTM16000) domicile (IHTM13000) 'at the time the settlement was made'. You should proceed on the basis that, for any given item of property (IHTM04030) held in a settlement, the settlement was made when that property was put in the settlement. Refer any case where this view is challenged to TG.
> *Example*
> S, when domiciled abroad, creates a settlement of Spanish realty. Later he acquires an UK domicile and then adds some Australian property to the settlement.
> The Spanish property is excluded property because of S's overseas domicile when he settled that property. However, the Australian property is not excluded property as S had a UK domicile when he added that property to the settlement.[34]

The relevant time in s.48(3) is not "the time when the property was settled"; it is "the time the settlement was made". HMRC seek to treat

33 This section considers the position where the *settlor* adds to a trust. For the position where others add to a trust, see ? (B adds property to A's trust).

34 This view is repeated in RI 166.

the transfer of an asset to an existing settlement as the making of a new settlement. It would follow that a person adding property to an existing settlement would be creating a second settlement or as many settlements as there are additions.

There is nothing conceptually impossible in HMRC's view that a separate settlement is deemed to be made where a person adds property to an existing settlement made by him.[35] But since adding property does not in fact create a new and separate settlement, two separate settlements do not exist,[36] one needs something express or implied in the legislation to deem what is in fact one settlement to be treated as two. When new property is added to an existing settlement, the new property *becomes comprised* in the settlement at that time, but that is not the same as saying the settlement (or a new settlement) was made at that time. The HMRC view leads to a more sensible result. But the legislation is so clearly inconsistent with the HMRC view that even a purposive construction cannot assist.[37]

Section 43 IHTA provides:

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35 This fiction is applied when there are two settlors, see ? (The separate settlements fiction). The same fiction could in principle apply when the settlor adds property to his own existing settlement.

36 This is self-evident but if authority is needed see *Truesdale v FCT* (1970) 120 CLR 353 at p.362 accessible *http://law.ato.gov.au*.

> "The words created a trust in s. 102 are not, I think, apt to describe the payment of money to a trustee to hold under a trust already constituted. There is an obvious difference between creating a trust in respect of property, on the one hand, and, on the other, transferring property to a trustee to hold upon the terms of an established trust. To read the section as if it applied to such a transfer would be, in the absence of a context, to expand it. Such a reading would be tantamount to saying that the transfer to the trustee of property to be held as part of the assets of an already constituted trust would be to create a second trust, whereas, from the point of view of both the trustee and of the beneficiary, there would be but one trust and the property transferred would be nothing more than an addition to the property subject to the trust."

Contrast Civil Procedure Rules 64.4(2) which distinguishes the person who created a trust from one who provided property for the purpose of the trust.

37 "It may be perfectly proper to adopt even a strained construction to enable the object and purpose of legislation to be fulfilled. But it cannot be taken to the length of applying unnatural meanings to familiar words or of so stretching the language that its former shape is transformed into something which is not only significantly different but has a name of its own. This must particularly be so where the language has no evident ambiguity or uncertainty about it." *Clarke v Kato* [1998] 1 WLR 1647 at p.1655.

> (1) The following provisions of this section apply for determining what is to be taken for the purposes of this Act to be a settlement, and what property is, accordingly, referred to as property comprised in a settlement or as settled property.
> (2) "Settlement" means any *disposition or dispositions* of property, whether effected by instrument, by parol or by operation of law, or partly in one way and partly in another, whereby the property is for the time being—
> (a) held in trust for persons in succession or for any person subject to a contingency, or
> (b) held by trustees on trust to accumulate the whole or part of any income of the property ... or
> (c) charged ... with the payment of any annuity ...
>
> (Emphasis added)

Perhaps the HMRC argument is that because a "settlement" means any disposition of property, each disposition constitutes a new and separate settlement. However, the words "any disposition or dispositions of property" indicate that more than one disposition can create a single settlement. One example would be where an original trust has been modified by a disposition by beneficiaries;[38] another would be where there have been separate dispositions to the same trust. So these words do not help the HMRC argument.[39] See *Rysaffe v IRC* [2003] STC 536 at [13]:

> Section 43 does not specifically address a numerical question: what is the number of relevant settlements existing in a particular inheritance tax situation? In the absence of specific statutory provisions the answer to the numerical question is to be found in the general law of trusts.

Further, the HMRC view is incompatible with many provisions of the IHTA. If each addition to an existing trust is a new settlement it makes nonsense of the added property provisions in s.67 IHTA and the many references to added property in the surrounding sections. It also makes

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38 See ? (The trust law background).

39 The drafter of the words "disposition or dispositions" almost certainly had in mind the reference to "instrument or instruments" and "compound settlement" in the earlier legislation and the comments in *Dymond's Death Duties*, 15th ed, p.129.

nonsense of the separate settlements fiction[40] which assumes (in the absence of s.44(2) IHTA) that one settlement may have two settlors.

The HMRC view is not consistent with s.49(5) FA 1977. This section clearly distinguished between:

(1) “the time when a settlement was made”, and
(2) “the time when [added] property was settled”.

It did so in the context of excluded property. The section is now repealed but the fact that the drafter took this view in 1977 remains relevant.

On the other hand, the transitional relief for the deemed domicile rule appears to assume the HMRC view, that excluded property status depends on domicile of the settlor at the time the property was added.[41] But overall this factor is outweighed by the others.

Dymond (I think) rejects HMRC’s view:

> When a settlor adds property to a settlement previously made by him it may be necessary to consider whether the addition counts as a new settlement. It if does, the settlor’s domicile has to be determined as at the time of the addition; but if not, his domicile at the date of the original settlement remains in point and any subsequent change of domicile is irrelevant.[42]

It might take litigation before HMRC amend their published stance on this issue but I think they would be advised not to fight. Until the point is clear, trustees should follow this advice in RI 166:

> **Trust records**
> ... the trustees of a settlement should keep adequate records to enable any necessary attribution of the settled property to be made if ...the settlor has added further assets to the settlement after it was made...

Suppose a settlor creates a trust when UK domiciled and adds property to it when foreign domiciled. On my view, none of the property is excluded property. However, HMRC must abide by their statement (at least until

40 See ? (The separate settlements fiction).
41 See ? (Pre-1974 transitional rules).
42 *Dymond’s Capital Taxes*, para 30.202.

it is officially and publically withdrawn with appropriate transitional relief) and accept the added property may be excluded property! Thus, the consequence of their statement (if my view is right) is that HMRC have the worst of both worlds. Of course, a well advised settlor will not find himself in this situation, but it does arise from time to time by accident.

44.15 Adding property to settlement after acquiring UK domicile: tax planning

It may be possible to avoid this problem if a foreign domiciled person contracts to assign future acquired property to a trust; provided that the contract is made while non-UK domiciled, domicile at the time of the transfer may not matter.

44.15.1 *Same settlor adds property to company held by trust after acquisition of UK domicile*

Suppose:

(1) A settlor creates a trust while domiciled outside the UK;
(2) The settlor becomes UK domiciled; and
(3) The settlor gives property to a company owned by the trust,

then HMRC's argument does not run at all. The shares in the company (if not UK situate) must be and remain excluded property. But watch out that the gift may be a gift with reservation and/or a chargeable transfer for IHT.

44.16 Occasions where excluded property is relevant for IHT

RI 166 states:

> However, an "excluded" asset is not always completely irrelevant for the purposes of IHT. So—
> [1] an "excluded" asset in a person's estate may still affect the valuation of another asset in the estate, for example, an "excluded" holding of shares in an unquoted company may affect the value of a similar holding in the estate which is not "excluded";
> [2] the value of an "excluded" asset at the time the asset becomes comprised in a settlement may be relevant in determining the rate of

> `any tax charge arising in respect of the settlement under the IHT rules concerning trusts without [estate] interests in possession—ss 68(5), 66(4) and 69(3).

This is correct, but point [1] does not arise in practice and point [2] will only rarely be significant.

44.17 Transfer of value by close company

Section 94 IHTA provides:

> **Charge on participators**
> (1) Subject to the following provisions of this Part of this Act, where a close company[43] makes a transfer of value, tax shall be charged as if each individual to whom an amount is apportioned under this section had made a transfer of value of such amount as after deduction of tax (if any) would be equal to the amount so apportioned, less the amount (if any) by which the value of his estate is more than it would be but for the company's transfer ...

Section 94(2) IHTA explains how the apportionment is made. It contains an exemption for foreign domiciliaries:

> if any amount which would otherwise be apportioned to an individual who is domiciled outside the UK is attributable to the value of any property outside the UK, that amount shall not be apportioned.

This exemption does not apply to exempt gilts because they are UK situate. This was presumably an oversight and the IHT Manual extends the exemption to cover this:

> **14854. Foreign aspects** [October 2007]
> [The Manual summarises the statutory exemption and continues:]

43 Section 102(1) IHTA provides a referential definition of "close company":
"In this Part of this Act—
'close company' means a company within the meaning of the Corporation Tax Acts which is (or would be if resident in the UK) a close company for the purposes of those Acts."

[1] A transfer of value by
- a company incorporated abroad (hence domiciled abroad - *Gasque v IRC* [1940] 2 KB 80) of
- property situate abroad

is **not** excluded property since s.6(1) IHTA only applies to individuals.
[2] Nevertheless, if such a company
- is resident abroad and
- makes a transfer of exempt Government securities within s.6(2) IHTA,

they **do** qualify as excluded property.[44]

There is no exemption for AUTs or OEICs but an HMRC concession would be sensibly consistent with the practice on exempt gilts.

44.18 Equitable interests in excluded property settlements

44.18.1 *Reversionary interest*

Section 48(3) IHTA[45] makes it clear that the non-settled property rules apply. An equitable interest which is a reversionary interest may be excluded property if it meets the conditions of s.48(1) or if it is not UK situate and owned by a foreign domiciliary.

44.18.2 *Interest in possession*

An equitable interest which is an estate IP is excluded properly only if it is owned by a foreign domiciliary and is not UK situate. However, the disposal of the interest is not a transfer of value; s.51 IHTA. Tax is charged under s.52 only if the settled property is not excluded property.

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44 Sentence [1] is not technically accurate. It would be strictly correct to say that *property* of a company incorporated abroad and situate abroad is not excluded property, because the definition of excluded property in s.6(1) only applies to property of individuals; however that is beside the point because (as the Manual has just noted) s.94(2) confers an equivalent exemption. But the important point here is that (however clumsily worded) sentence [2] extends the exemption to exempt gilts.

45 Set out at 44.8 (Trusts: foreign situate property).

44.19 Non-residents foreign currency bank accounts

44.19.1 *Individual's account*

Section 157(1)(a) IHTA provides a limited relief for non-residents foreign currency bank accounts:

> (1) In determining for the purposes of this Act the value of the estate immediately before his death of a person to whom this section applies there shall be left out of account the balance on—
> (a) any qualifying foreign currency account of his,
>
> (5) In this section "qualifying foreign currency account" means a foreign currency account with a bank[46]; and for this purpose—
> (a) "foreign currency account" means any account other than one denominated in sterling.

Section 157(2) IHTA explains who qualifies for the relief:

> This section applies to a person who is not domiciled in the UK immediately before his death, and is neither resident nor ordinarily resident[47] there at that time.

44.19.2 *Trustees bank account*

Section 157(1)(b) IHTA provides a similar restricted relief for trustees foreign currency bank accounts:

> (1) In determining for the purposes of this Act the value of the estate immediately before his death of a person to whom this section applies there shall be left out of account the balance on ...

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46 Section 157(6) provides: "In this section 'bank' has the meaning given by section 991 of the Income Tax Act 2007."

47 Section 157(4) incorporates the income tax definitions of residence and ordinary residence of individuals:
"For the purposes of this section—
(a) the question whether a person is resident or ordinarily resident in the UK shall, subject to para (b) below, be determined as for the purposes of income tax;"
(Para (b) deals with trustee residence, discussed below).

(b) subject to subsection (3) below, any qualifying foreign currency account of the trustees of settled property in which he is beneficially entitled to an interest in possession.

(3) Subsection (1)(b) above does not apply in relation to settled property
[a] if the settlor was domiciled in the UK when he made the settlement, or
[b] if the trustees are domiciled, resident or ordinarily resident in the UK immediately before the beneficiary's death.

For the definition of trust residence see ? (Trust residence for IHT). Domicile presumably depends on the domicile of the trustees in their personal capacity (the rule that trustee domicile should be relevant is difficult to understand.)

44.19.3 *Overdrawn account*

The IHT Manual provides at para 4380:

> Where the conditions are met, the balance on the account, whether in credit or in debit should be left out of account. You should refer any case of difficulty, especially if you are seeking to disallow a debit balance, to TG.

The second sentence suggests, perhaps, that HMRC are not entirely confident in this interpretation. It seems literally correct on a first reading, and provides a certain symmetry of treatment with accounts with a positive balance; on the other hand it is a daft rule, a petty trap easily avoided by the well advised, and inconsistent with the general approach of deduction for debts.[48] I do not think it could have been the intention of Parliament.

44.19.4 *Discussion*

This is a limited relief. The bank account is *not* excluded property for IHT purposes. It is only disregarded on the death of the owner or life tenant, so it is taken into account for lifetime gifts of individuals, and ten-year

48 See ? (Deduction for debt of foreign domiciled individual).

anniversary charges on trusts. The conditions for the relief are also stricter than for excluded property. It would in almost all cases be better to use a foreign bank account (which will be excluded property) rather than to rely on this exemption.

If the purpose of the relief is to encourage non-residents to deposit funds with UK banks, these restrictions make no sense. It is suggested that foreign currency accounts (indeed all accounts) ought simply to qualify as excluded property. That change would also ensure the deductibility of overdrawn accounts. Otherwise the relief is just clutter in the system and if (as I expect) it is not much used it would be better to repeal it.

44.20 Works of art

Section 5(1) IHTA provides a pragmatic relief for works of art:

> For the purposes of this Act a person's estate is the aggregate of all the property to which he is beneficially entitled, except that ...
> (b) the estate of a person immediately before his death does not include ... a foreign-owned work of art which is situated in the UK for one or more of the purposes of public display, cleaning and restoration (and for no other purpose).

Similarly, section 64(2) (charge at ten-year anniversary) provides:

> For the purposes of subsection (1) above, a foreign-owned work of art which is situated in the UK for one or more of the purposes of public display, cleaning and restoration (and for no other purpose) is not to be regarded as relevant property.

Section 272 IHTA defines these terms:

> "foreign-owned", in relation to property, means property in the case of which the person beneficially entitled to it is domiciled outside the UK or, if the property is comprised in a settlement, in the case of which the settlor was domiciled outside the UK when the property became comprised in the settlement;
> "public display" means display to which the public are admitted, on payment or not, but does not include display with a view to sale;.

The reason is self-evident. Dawn Primarolo (then Financial Secretary to the Treasury) explained :

> The Inland Revenue's ESC F7 allows exemption from inheritance tax for works of art when they are only chargeable under strict law because they have been brought temporarily to the UK for cleaning or restoration, or for loan to an exhibition. That reflects a longstanding judgement that the public interest would not be served if foreign owners of works of art were unwilling to send them to the UK for these purposes for fear of a potential inheritance tax charge.[49]

This relief falls short of a complete exemption but in practice it is sufficient, and the issues are not sufficiently important to discuss further here.

44.21 IHT planning for individual

A foreign domiciliary should endeavour to secure, as far as possible, that his assets are situated outside the UK so that they qualify as excluded property and fall outside the inheritance tax net. The foreign domiciliary's property becomes excluded property the moment that it becomes non-UK situate; there is no qualifying period such as is required for other inheritance tax reliefs. The same applies to trustees of a settlement made by a foreign domiciliary. The question is: how is the individual's property to be transferred abroad?

The transfer abroad of £ Sterling from a UK bank account poses no problem. The transfer of bearer instruments abroad raises no problem. The transfer abroad of foreign currency in a UK bank account abroad needs careful consideration as to CGT. Chattels could be physically moved abroad but that may not be practical.

It is possible to turn UK situate shares and securities into non-UK situate assets for IHT: see ? (Bearer documents).

Any UK asset could be sold and the proceeds remitted abroad. This is simple and satisfactory for inheritance tax; however, a sale may be ruled out by CGT or commercial reasons.

If the foreign domiciliary does not wish assets to be sold, he might give them to a company owned wholly by him. The shares in the company

49 Ministerial Statement 25 February 2003 [2003] STI 303.

should not be UK situate and may be unnecessary for IHT.[50] The company should normally be non-resident. The gift would not be a transfer of value for IHT because the donor's estate would not be reduced in value. It is considered that it is not a disposal by way of gift, as there is no gratuitous intent. In *Shiu Wing v Commissioner of Estate Duty*[51] the Hong Kong Court of Final Appeal refused to apply the *Ramsay* doctrine to arrangements made by the taxpayer to create property situated abroad (in this case situated outside Hong Kong). The gift would, of course, be a disposal for CGT purposes and hold-over relief would not normally be available. Accordingly, this option will only be a satisfactory solution either if no capital gain arises or if hold-over relief is available.[52]

If the individual is in good health, there is a lot to be said for doing nothing and ignoring IHT planning. The only inheritance tax risk in this strategy is that the individual might die so suddenly that no steps to save tax can be taken. This risk is reduced (but not eliminated) if the spouse exemption is available. It might be possible to take out insurance. In principle it is clearly undesirable to allow a beneficiary in poor health to retain an interest in possession in non-excluded property.

44.22 IHT planning for non-estate IP trusts

A discretionary trust (and a non-estate IP trust) is subject to IHT on its ten-year anniversaries. If the settlor is not UK domiciled when he made the trust, all that matters for IHT is the situs of the trust fund on that date.[53] The trustees may safely invest in the UK for a number of years, provided that, by the deadline, they hold foreign situate assets.

In principle this short-term planning may be extended indefinitely:

(1) As each ten-year anniversary approaches the trustees could sell the UK trust property (or even mortgage it) and invest in excluded

50 See ? (Situs of registered shares) and ? (Bearer documents).

51 2 ITELR 794.

52 A gift to the company by way of *donatio mortis causa* solves the CGT problem: s.62(5) TCGA. But such a gift is not effective for inheritance tax purposes. The donor retains the right of revocation which would not be excluded property on his death.

53 Note also the possible tax charge on the death of the settlor, under the gift with reservation rules, if the property is UK situate: see ? (GWR death charge: excluded property rules for settled property) and following.

property.

(2) Immediately after the anniversary they might sell and revert to UK investments.

In practice such a course might be subject to *Ramsay* but it depends on how it is done.[54] Ideally the trustees should look for a different strategy such as holding the UK assets in a foreign registered company.

44.23 IHT planning for trustees of settlement with UK domiciled settlor

If the settlor is UK domiciled when the settlement was made, trust property is not normally excluded property even if the beneficiary is foreign domiciled.

44.23.1 *Beneficiaries not ordinarily resident*

If the life tenant is ordinarily resident out of the UK, the trustees might invest in exempt gilts. The trust property would then be excluded property. See 44.11 (Trusts: exempt gilts).

Likewise if all the known beneficiaries of a discretionary trust are ordinarily resident abroad. This option is not available if any of the beneficiaries are domiciled or ordinarily resident in the UK. A deed of appointment might be needed to satisfy these conditions. This would give rise to an exit charge unless the settlor is foreign domiciled when the settlement was made: see s.65(8) IHTA. However, the amount of the charge may be moderate or small.

44.23.2 *UK settlor: foreign domiciled beneficiary*

The best option – if circumstances allow – may be to bring the present settlement to an end by appointment to the foreign domiciled beneficiary absolutely. CGT needs consideration if the trust is UK resident. The beneficiary may after an appropriate period re-settle. This may also be

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54 A similar point has often been litigated in the US: see *Holly Springs Savings & Insurance Co v Board of Sup'rs of Marshall County* 52 Miss. 281, 24 Am. Rep. 668 (1876); *Jones v Steward County*, 10 Neb. 154, 4 N.W. 946 (1880); *Mitchell v Leavenworth County* 91 US. 206, 23 L. Ed. 302 (1875) (US Supreme Court); *Re People's Bank of Vermont, Ill.*, 203 Ill 300, 67 N.E. 777 (1903).

appropriate where the settlor has become foreign domiciled after making the settlement.

An alternative course may be to confer a general testamentary power on the foreign domiciled beneficiary. The beneficiary may on his death create a new trust with excluded property.

44.23.3 *Life tenant domiciled in Channel Islands or Isle of Man but deemed UK domiciled*

For this rare case, see 44.6 (Individual domiciled in Channel Islands or Isle of Man).

CHAPTER FORTY FIVE

RESERVATION OF BENEFIT

45.1 GWR – Introduction

Here is a rendezvous of questions and question marks! A full discussion needs a book to itself. This chapter concentrates on difficult but important issues which commonly arise in relation to the foreign domiciliary. The IHT Manual contains much fascinating material which cannot be set out here for reasons of space.

Section 102(1) FA 1986 provides:

> ... this section applies where, on or after 18 March 1986, an individual disposes of any property by way of gift and either—
> (a) possession and enjoyment of the property is not bona fide assumed by the donee at or before the beginning of the relevant period;[1] or
> (b) at any time in the relevant period the property is not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor and of any benefit to him by contract or otherwise ...

There are two sets of conditions:

(1) An individual (in this chapter "**the donor**") makes a disposal of property by way of gift. There are three separate elements here: a *disposal*, of *property*, which must be *by way of gift.*
(2) Condition (a) or (b) above must be satisfied (a reservation of benefit).

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1 Section 102(1) provides:
"in this section 'the relevant period' means a period ending on the date of the donor's death and beginning seven years before that date or, if it is later, on the date of the gift."

45.2 Terminology

Section 102(2) FA 1986 provides one defined term:

> If and so long as—
> (a) possession and enjoyment of any property is not bona fide assumed as mentioned in subsection (1)(a) above, or
> (b) any property is not enjoyed as mentioned in subsection (1)(b) above,
> the property is referred to (in relation to the gift and the donor) as property subject to a reservation.

In the following discussion:

(1) "**GWR property**" is property subject to a reservation.
(2) "**Settled GWR property**" is GWR property which becomes settled property by the gift (i.e. the gift is to a settlement).
(3) "**Non-settled GWR property**" is GWR property which does not become settled property by the gift (i.e. the gift is not to a settlement).
(4) "**The GWR death charge**" is the charge imposed by s.102(3) FA 1986.
(5) "**The GWR PET charge**" is the charge imposed by s.102(4) FA 1986.

45.3 Disposal before 18 March 1986

The GWR rules only apply to disposals on or after 18 March 1986. The IHT Manual states correctly at 14311:

> [January 2008] A pre-18 March 1986 settlement which would have been caught by the GWR provisions had it been made after 17 March 1986 will therefore escape the GWR charge unless further gifts into settlement are made after that date. The GWR provisions will apply to the property settled by those further gifts. ...
> *Example*
> On 1 January 1985 the donor settled £100,000 on discretionary trusts under which he was a potential beneficiary. On 1 January 1989 he added a further £50,000 to the settlement. The donor dies 1 April 1992 having remained a potential beneficiary throughout.
> The GWR provisions apply to the 1989 addition but not to the property originally settled. The GWR claim extends to the assets in the settled fund at 1 April 1992 representing that £50,000. The Double Charges Regulations (IHTM 14711) will be in point.

But GWR will apply to pre-1986 settlements on the termination of an estate IP.[2]

45.4 When is there a "disposal by way of gift"?

There are some general issues on the meaning of a "disposal by way of gift". Is the surrender of a lease or life interest a "disposal"? Or the giving of consent to an exercise of a power of advancement or appointment? Is a sale at an undervalue "by way of gift"? Or a transfer to a settlement in which the settlor has an interest in possession? But such questions arise only occasionally in relation to foreign domiciliaries and are not considered here. Generally one is dealing with gifts where the position should be clear.

It is considered that a sale at market value, where the purchase price is left outstanding as an interest-free loan, repayable on demand, is not a disposal "by way of gift".

45.5 When is there a reservation of benefit?

The words used in the statute are remarkably obscure. While in most cases the matter will be clear enough there are significant areas of uncertainty. Some doubtful areas have been resolved for practical purposes by HMRC statements.

45.5.1 *Gift to discretionary trust, settlor a beneficiary*

IHT Manual para 14393 provides:

> **Settlement on discretionary trusts** [February 2006]
> If a donor makes a settlement and is one of the members of the discretionary class of beneficiaries, this is a GWR.
> - The donor's position as a member of the discretionary class of beneficiaries is not an equitable interest retained by them (and so not included in the gift)
>   and
> - as the donor is a member of the class, they have not been excluded

2 See 45.15 (GWR on termination of IP).

(IHTM14333), or virtually excluded, from enjoyment. The fact that they do not receive any tangible benefit during the relevant period is immaterial.

This is correct.[3] It is considered that the same applies where an individual makes a gift to a discretionary trust under which:

(1) the settlor is not included in the class of beneficiaries; but
(2) the trustees have an unrestricted power to add the settlor to the class of beneficiaries.[4]

45.5.2 *Gift from A to B followed by gift to trust by B*

The position is different where:

(1) A makes a gift to B.
(2) Later, by an independent transaction, B creates a discretionary trust under which A is a beneficiary (or where A can be added as a beneficiary).

In these circumstances A is *not* the settlor. It is considered that there is no reservation of benefit merely because A is a discretionary beneficiary. There will be a reservation of benefit if A actually receives a benefit.

45.6 IHT on the disposal by way of gift

A gift which is a chargeable transfer will give rise to a charge to IHT (assuming it exceeds the nil rate threshold) whether or not it is a gift with a reservation.[5] The reservation of benefit does not affect this charge; just

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3 *IRC v Eversden (Greenstock's Executors)* 75 TC 340. (The Court of Appeal did not consider this point.)

4 The HMRC view is, however, equivocal. The IHT Manual provides at IHTM14393: "The question of whether the possibility that A's name might be added to the class is a reservation is one which you can only determine on the particular facts. Refer any case where the point is material to the Litigation Section (IHTM01083)".

5 The IHT Manual makes this somewhat elementary mistake in para 14316:

> "Example 1
> In 1989 the donor sold a house, then worth £100,000, to his son for £25,000.

on the death of the donor there may be a further charge to tax. The Inheritance Tax (Double Charges Relief) Regulations 1987 mitigate a double charge. This chapter does not consider the IHT which might arise on a gift; it considers only the GWR aspects.

45.7 Gift of excluded property

Section 102 FA 1986 applies when an individual disposes of any property by way of gift. A foreign domiciliary is certainly "an individual". A gift of UK situate property by a foreign domiciliary is clearly within the GWR rule.

What is the position where a foreign domiciliary disposes of excluded property by way of gift? There is nothing which expressly takes the gift out of the scope of the GWR rules. However, it is considered that s.3(2) IHTA does so obliquely. Section 3 IHTA provides:

> **Transfers of value**
> (1) Subject to the following provisions of this Part of this Act, a transfer of value is a disposition made by a person (the transferor) as a result of which the value of his estate immediately after the disposition is less than it would be but for the disposition; and the amount by which it is less is the value transferred by the transfer.
> (2) For the purposes of subsection (1) above no account shall be taken of the value of excluded property which ceases to form part of a person's estate as a result of a disposition.

This is a disposition partly by way of sale and partly by way of gift. The donor dies in 1993.

- If the donor has been excluded from enjoyment of the property throughout the period, the gift is a PET chargeable on his death. The loss to his estate is the value of the entirety of the property less the consideration received (£100,000 less £25,000 = £75,000).
- If the donor was not excluded from enjoyment of the property, for instance because he resided at the property following the disposition, the disposal by way of gift is a GWR. The value of the property disposed of by way of gift is 75% of the value of the whole property. Thus, if the property is still subject to a reservation immediately before the donor's death, 75% of its death value is treated as property to which the donor was beneficially entitled."

On a literal approach to construction this makes no difference. The fact that no account is taken of the value of excluded property for the purposes of s.3(1) does not mean that the disposition is not a "disposal by way of gift". However, a purposive construction suggests otherwise. It is absurd that there should be a charge to tax in circumstances where:

(1) a foreign domiciliary with no UK connection makes a gift of excluded property to another person with no UK connection, and enjoys some benefit; and
(2) the foreign domiciliary dies many years later at a time when property representing the property given is situate in the UK.

Nobody would expect the foreign domiciled donor or his executors to comply or to be able to comply with an obligation to pay IHT in such circumstances. The purpose of s.3(2) IHTA is to take excluded property out of the scope of inheritance tax and a disposal of excluded property is by implication ignored. Since it is ignored it is not a disposal "by way of gift". This conclusion is also supported by the use of the term "excluded property" – the property is regarded as excluded from IHT.

HMRC do not appear to accept this view.

45.8 GWR spouse exemption

This section considers the GWR position on inter-spouse gifts. For other IHT spouse exemption issues see 45.18 (IHT spouse exemption defence to GWR death charge), 49.2 (IHT spouse exemption on death of a foreign domiciliary); 53.2 (Restriction on IHT spouse exemption for foreign domiciled spouse).

Section 102(5) FA 1986 provides a relief which I call the "**GWR spouse exemption**":

> This section does not apply if or, as the case may be, to the extent that the disposal of property by way of gift is an exempt transfer by virtue of any of the following provisions of Part II of the [IHTA],—
> (a) section 18 (transfers between spouses or civil partners) ... ;

In short, the GWR rules do not apply on gifts between spouses if the IHT spouse exemption applies.[6]

Where a UK domiciled individual makes a gift to a foreign domiciled spouse, the IHT spouse exemption is restricted to £55,000 and a gift over that limit will be within the scope of GWR, unless some other exemption is in point.[7] One solution to this problem is to sell assets at market value, so there is no disposal by way of gift. Watch the SDRT/SDLT implications.

45.8.1 *Inter-spouse gift of excluded property exemption*

What is the position when a foreign domiciled individual makes a gift of excluded property to his spouse? On a literal construction, the gift will fall within the GWR rules. A gift of excluded property is not a transfer of value, so outside the scope of the IHT spouse exemption, so it is outside the scope of the GWR spouse exemption! But that is absurd and cannot be the correct construction, even if words must be strained to reach this result. This consideration supports the view taken here that gifts of excluded property, and gifts within s.11 IHTA, are deemed not to be by way of gift.[8]

Such property is nevertheless "subject to a reservation" and so qualifies for the GWR exemption to the pre-owned asset rules.

45.9 GWR death charge

Section 102(3) FA 1986 provides:

> If, immediately before the death of the donor, there is any property which, in relation to him, is property subject to a reservation then ... that property shall be treated for the purposes of the [IHTA] as property to which he was beneficially entitled immediately before his death.

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6 I use the term "**IHT spouse exemption**" to refer to the exemption on inter-spouse transfers in s.18 IHTA. See 45.18 (IHT spouse exemption defence to GWR death charge).

7 Such as the family maintenance exemption: see ? (Disposition for maintenance of spouse an other exemptions).

8 If my view were wrong the further anomaly would arise that gifts of qualifying investments to charity would fall within the scope of GWR because such gifts fall within s.12 IHTA and not s.102(5)(d) FA 1986; but it is not necessary to pursue that here.

I refer to this as "**the GWR death charge**". Section 102(3) is a deeming provision; the donor is not in fact beneficially entitled to the property subject to the reservation but the property is treated as if he were so entitled. To understand the significance of this, it is necessary to set out the short series of sections that normally impose an inheritance tax charge on property to which a person is beneficially entitled at death.

Section 4(1) IHTA imposes the IHT charge on death:

> On the death of any person tax shall be charged as if, immediately before his death, he had made a transfer of value and the value transferred by it had been equal to the value of his estate immediately before his death.

The key word here is "estate". Section 5(1) IHTA defines estate by reference to beneficial entitlement:

> .... a person's estate is the aggregate of all the property to which he is beneficially entitled, except that ...
> (b) the estate of a person immediately before his death does not include excluded property ...

So if there is a GWR until death and the property is *not* excluded property:

(1) the property is treated as property to which the donor was beneficially entitled (in all cases);
(2) the property is part of his estate.

If there is a GWR until death and the property *is* excluded property:

(1) the property is treated as property to which the donor was beneficially entitled (in all cases);
(2) the property is not part of his estate.

45.10 GWR over debt owed by the deceased

Suppose:

(1) S creates a discretionary settlement under which he is a beneficiary;
(2) the trustees lend to S;

(3) S dies.

The debt ("the GWR debt") is treated as being in the estate of S. However a person cannot owe a debt to himself. If the GWR debt is treated as property beneficially owned by the debtor, it must be treated as if it ceased to exist. For this reason there is no IHT charge on the debt under the GWR rules, on the death of S, even if the GWR debt is UK situate.[9]

45.11 GWR death charge: excluded property rules for non-settled property

Suppose:

(1) A gives property to B, an individual, outright.
(2) There is a reservation of benefit: A enjoys benefits at the time of his death.
(3) The property is not UK situate at the time of A's death.

A is treated as if he were beneficially entitled to the property at the time of his death. It forms part of his estate unless it is excluded property at that time. How do the excluded property rules work in these circumstances?

Here we are concerned with non-settled property. The relevant rule is that:

> Property situated outside the UK is excluded property if the person beneficially entitled to it is an individual domiciled outside the UK.[10]

In the example above, B is *in fact* beneficially entitled to the property. A is *treated* as beneficially entitled. Who is "beneficially entitled" for the purpose of applying the excluded property rule; is it A or is it B? This does not matter if A and B are both foreign domiciled, but it does if one is and the other is not. One common case is in a gift from a UK domiciled

9 If the debt is non-UK situate it may also be outside the scope of IHT because of the excluded property rules. On the question of a deduction for the GWR debt, see ? (Debt subject to GWR).

10 Section 6(1) IHTA.

donor to his foreign domiciled spouse.[11]

45.11.1 *Construction of deeming provisions*

The answer is to be found by applying the general rule of construction which applies to deeming provisions:

> If you are bidden to treat an imaginary state of affairs as real, you must surely, unless prohibited from doing so, also imagine as real the consequences and incidents which, if the putative state of affairs had in fact existed, must inevitably have flowed from or accompanied it.[12]
>
> ... [B]ecause one must treat as real that which is only deemed to be so, one must treat as real the consequences and incidents inevitably flowing from or accompanying that deemed state of affairs[13]...

But context can show that the general rule should not be applied. It is merely a general canon of construction from which "only limited assistance can be derived in choosing between alternative interpretations of the Act".[14] Experience shows that Parliament has often failed to foresee all the consequences of its deeming and nowadays the courts apply deeming provisions in a context sensitive manner.[15]

45.11.2 *Conclusion*

Applying this principle it follows that the domicile of the donor A is what matters for excluded property status. Thus if A has a foreign domicile, the property (if not UK situated) is excluded property. The domicile of the donee B is irrelevant. This conclusion is confirmed by the context. It

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11 See 45.8 (GWR spouse exemption).

12 Lord Asquith, *East End Dwellings Co Ltd v Finsbury Borough Council* [1952] AC 109 at p.132.

13 *Marshall v Kerr* 67 TC 56, at p.79A.

14 *Russell v IRC* [1988] STC 195 at p.205.

15 In *Murphy v Ingram* [1973] Ch 363 at p.446 Megarry J said:

> A research student in search of a suitable topic for a thesis might do worse than to choose as his subject "the Dangers of Deeming".

But the modern approach reduces these dangers and *Murphy* itself would be decided differently today. For an example, see *De Rothschild v Lawrenson* 67 TC 300 at p.316.

would be absurd if the taxation of A depended on the domicile of B. The taxation of A should depend on his own domicile position.

For the purposes of the excluded property rule, therefore:

(1) The domicile of the donor at the time of gift is irrelevant (contrast the position where the gift is made in trust.[16]
(2) The situs of the property at the time of the gift is irrelevant to the operation of the excluded property rules on the death of the donor.

HMRC accept this. IHT Manual 14318 provides:

> **Excluded property** [August 2006]
> Under the charging provisions (IHTM04072), excluded property (IHTM04251) cannot be the subject of a GWR.
> It is excluded property is settled, consider the further instructions (IHTM14396).
> *Example*
> The donor, an Australian, gives Australian shares to his Australian[17] son but continues to enjoy the dividends until his death ten years later. He dies domiciled in Australia.
> The property is property subject to a reservation and is therefore deemed to be part of the donor's death estate. However, the property is situate outside the UK *and the donor, who is treated as beneficially entitled to it, was domiciled outside the UK at his death*. The property is therefore excluded property within IHTA s 6(1) and escapes the GWR charge.
>
> (Emphasis added)

The Manual continues:

> However, if the donor had returned to the UK[18] there may be a GWR claim on his death.

16 See 45.12 (GWR death charge: excluded property rules for settled property) below.

17 Although in the example the son (the donee) has (presumably) an Australian domicile, the result would be the same if the son had a UK domicile, as the italicised words show.

18 "Returned to the UK" is untechnically expressed: the author of the Manual means to say (or should say) that if the donor has acquired a UK domicile for IHT purposes at the time of his death, there may be a GWR claim on his death.

I do not know why HMRC say there *may* be a GWR claim. On their view there *would* be a GWR claim. Perhaps the point is that the value may fall within the IHT nil rate band. Perhaps the author was considering the argument that GWR does not apply on a gift of excluded property.

The same applies to gifts to companies, including companies held by trusts.

45.12 GWR death charge: excluded property rules for settled property

Suppose:

(1) S (not UK domiciled) gives property to a discretionary settlement.
(2) There is a reservation of benefit, e.g. S is a beneficiary.
(3) The property is not UK situate[19] at the time of the death of S.

S is treated as if he were beneficially entitled to the property at the time of his death. It forms part of his estate unless it is excluded property at that time. How do the excluded property rules work in these circumstances?

45.12.1 *The rival solutions*

There are two sets of excluded property rules, relating to settled and non-settled property. Which does one apply?

(1) *The Settled Property Solution*

The property subject to a reservation is in fact settled property, so on this view one applies the settled property rules set out in s.48(3) IHTA:

> Where property comprised in a settlement is situated outside the UK—
> (a) The property ... is excluded property unless the settlor was domiciled in the UK at the time the settlement was made.

So on this view, where an individual makes a gift to a settlement with reservation of benefit, and dies, the property is excluded property for the GWR rules if:

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19 The position is the same if the property consists of UK AUTs or OEICs, but for convenience I refer to non-UK situate property only.

(1) the donor is domiciled outside the UK at the time the settlement was made. (The domicile of the donor at the time of death is irrelevant); and
(2) the property is not situated in the UK at the time of death.

I call this "**the Settled Property Solution**".

(2) *The Non-settled Property Solution*

The settled property GWR is to be treated as property to which the donor is "beneficially entitled". On this view one applies the deeming provision to its logical conclusion: if a person is beneficially entitled to property, it is not settled property. So on this view, where an individual makes a gift to a settlement with reservation of benefit, and dies, the property is excluded property for the GWR rules if:

(1) the donor was domiciled outside the UK at the time of his death. (The domicile of the donor at the time the settlement was made is irrelevant for GWR, though it is relevant for other purposes); and
(2) the property is not situated in the UK at the time of death.

I call this "**the Non-settled Property Solution**".

45.12.2 *The correct solution*

The Non-settled Property Solution has supporters.[20] Nevertheless it is generally regarded as wrong. What about the deeming provision that the property is to be treated as if the donor were beneficially entitled to it? The answer is that the property must still be regarded as "settled property" for the application of the excluded property rules. One does not carry the implications of the deeming provisions as far as the Non-settled Property Solution suggests. One way to reach this conclusion is to note that the deeming provision does not deem the donor to be beneficially and *absolutely* entitled to the settled property. One can be beneficially entitled to property which is settled property. (Bear in mind that "settlement" has

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20 "Excluded Property Trusts and GROBs" Robert Venables QC [2003] OITR Vol 11 p.75. Barrie Akin agrees: *GITC Review*, Vol 1 Issue 2, p.1, accessible *www.taxbar.com*.

a wide definition for IHT. It includes property held subject to a contingency, property charged with the payment of an annuity, and a lease for life. A person entitled to such property may nevertheless be said to be "beneficially" entitled.)

This view is strongly supported by s.49(1) IHTA which provides:

> A person beneficially entitled to an interest in possession in settled property shall be treated for the purposes of this Act as *beneficially entitled* to the property in which the interest subsists.
>
> [Emphasis added]

No-one suggests that property to which s.49(1) applies is to be treated as non-settled property for the purposes of the GWR rules. The wording of the deeming provision in s.102(3) is materially the same.

Under the Non-settled Property Solution, the property is simultaneously excluded property (for general IHT purposes) and non-excluded property (for GWR purposes). While that is not impossible, it would be remarkable, even in as convoluted an area as this, and for this reason too the Settled Property Solution is to be preferred.

It has been said that a purposive construction favours the Non-settled Property Solution: the purpose of the GWR rules is to put the donor in the same position as if he had not made the gift. This is the general purpose in the case of gifts by UK domiciliaries. However, arguments on purposive construction only run when one knows the general purpose and is confident that the general purpose applies in the particular circumstances of the case. This argument *assumes* that that purpose necessarily extends to the foreign domiciliary – which begs the question. Perhaps Parliament intended there to be a difference between the two cases. One cannot apply a purposive construction unless the purpose is clear.[21]

Trustees should bear in mind that, even in adopting the Settled Property

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21 In the battle of the anomalies HMRC might instance the case where a foreign domiciliary made a settlement shortly before becoming UK domiciled, and say that it is absurd that a settlement made in such circumstances should avoid IHT on the death of the settlor. But (1) this is certainly the case where the foreign domiciliary enjoys no benefit from the settlement; and (2) this was the case under estate duty; and (3) this was the case under HMRC practice in the first 15 years or so of IHT; in the circumstances it is wrong (if not absurd) to describe that result as absurd.

Solution, there will arguably[22] be a charge to IHT on the death of a settlor who enjoys a benefit over trust property if at the time of his death:

(1) trust property is UK situated (and not UK AUTs or OEICs); and
(2) the property was given to the trust on or after 18 March 1986.

If the settlor is a beneficiary it is safer not to invest directly in UK situate property during his life.

Note that the Non-settled Property Solution favours the taxpayer if a UK domiciliary makes a GWR settlement, and becomes non-UK domiciled before his death. However that won't often happen.

45.12.3 *HMRC view(s)*

Until 2001 HMRC agreed with the Settled Property Solution. The former Capital Taxes Office Advanced Instruction Manual D.8 provided:

> *Example 2*
> The donor, who is domiciled in Australia, puts foreign property into a discretionary trust under which he is a potential beneficiary. He dies five years later domiciled in England and without having released the reservation.
> The property is property subject to a reservation and is therefore deemed to be part of the donor's death estate. *However, as he was domiciled outside the UK at the time the settlement was made, the property will be excluded property, under IHTA, s 48(3), if still situate outside the UK at the date of death.*[23]

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22 See 45.7 (Gift of excluded property).

23 *Law Society's Gazette* 1986 p.3728 provided:

> **Question:**
> 'G' a non-domiciliary gifts excluded property into a discretionary settlement under which he is in the class of beneficiaries. 'G' dies domiciled in the UK. Are the "excluded property" assets in the settlement treated as part of 'G's estate?
> **Answer from The Controller, Capital Taxes Office**:
> Here it seems to me that the settled property would be "property subject to a reservation" in relation to the settlor. Accordingly it would fall within s102(3) of the Finance Act 1986 to be treated as property to which he was beneficially entitled immediately before his death. The effect would be to lock the property into the settlor's estate within the meaning of s5(1) of the

Astonishingly, the text was changed (without public announcement) in about October 2001.[24] The change implied HMRC had reversed their view and adopted the Non-settled Property Solution. HMRC said informally that they were in fact reconsidering their position on this point and had not reached a final view. Since then, nothing has happened.

The IHT Manual is a sorry muddle:

> **14396 - Domicile of the settlor** [October 2007]
> The charging provisions [for GWR] (IHTM04072) denote that property in which the deceased retained a beneficial interest (IHTM04031) forms part of their estate unless it is excluded property (IHTM04251).

This is not technically accurate,[25] but the point it is trying to make is correct. The Manual continues:

> If the settlor was domiciled outside the UK at the time a settlement was made, any foreign property within that settlement is excluded property and is not brought into charge for inheritance tax purposes. You can find more detailed instructions about this aspect in the foreign property (IHTM27220) section of this manual.
> **Change of domicile**
> Foreign property settled by a settlor with foreign domicile remains excluded property if the reservation continues **up to the settlor's death**, even though the domicile may have changed between those dates.

(Emphasis in original) This passage adopts the Settled Property Solution. The Manual continues:

> **Example**
> The donor, who is domiciled in Australia, puts foreign property into a discretionary trust under which he is a potential beneficiary. He dies five years later domiciled in the UK and without having released the reservation (IHTM14393).

IHTA which is subject to the exception for "excluded property". It would follow that in the case of settled property, relief for foreign assets could continue to be available under section 48(3).

24 The last sentence was changed to read:
"Any cases where this is the situation must be referred to the Litigation Team."

25 "Property in which the deceased retained an interest" should read "property subject to a reservation"; and the GWR property only "forms part of their estate" on death.

> The property is subject to a reservation and is therefore deemed to be part of the donor's death estate.
> Refer any cases where this is the situation to Litigation.

The example adopts the Non-settled Property Solution. But the text which follows reverts to the Settled Property Solution: see 45.14 (GWR PET charge).

45.12.4 *Transitional relief if Non-settled Property Solution is correct*

In the case of gifts made before October 2001 with UK professional advice, the taxpayer (through his advisors) will have relied on the published HMRC statements; and HMRC cannot properly seek to charge tax on the basis of the Non-settled Property Solution even if (contrary to the view taken here) a tax charge arises.

HMRC have said informally that no tax would be sought where taxpayers have relied on their previous view but the exact details of this transitional relief have not been decided.

For gifts made after the text of the Manual changed, HMRC are entitled to argue for the Non-settled Property Solution. The settled property solution was restated in the 2003 Background Paper on Domicile at 2.8 but the authors were probably not aware of the HMRC dithering, and that statement does not bind HMRC.

In the case of gifts made before October 2001 without UK advice, it is suggested that HMRC cannot properly take this point, but the position is rather less clear.

It is considered that if HMRC argue for the Non-settled Property Solution, they will eventually be defeated in the courts so the issue of transitional relief will not arise.

It is not realistic to expect that tax legislation should always be clear. It is realistic to expect HMRC to make up their minds on points of general importance. The reader may well think that enough time has passed since the bombshell in 2001 to form a considered view and publish it. In practice it appears that HMRC are not seriously pursuing the Non-settled Property Solution.

45.13 Gift to foreign domiciled donee who creates a settlement

Suppose:

(1) A makes an outright gift to B.
(2) B makes a gift of that property to a settlement.
(3) A is a beneficiary of that settlement and enjoys benefits so that there is a reservation of a benefit in relation to A's gift.
(4) B (and not A) is the settlor of the settlement; see ? (Gift from A to B followed by gift to trust by B).

Now which set of excluded property rules is applied? It is suggested that one must apply the rules applicable to settled property for the reasons given in 45.12 (GWR death charge: excluded property rules for settled property). FA 1986 Sch. 20 para 5 needs to be considered but, properly understood, nothing there deems A to be the settlor of the settlement. If that is right, there is no reservation of benefit problem if:

(a) B (the settlor) was not domiciled in the UK when the settlement is made; and

(b) the property is not situated in the UK at the time of the death of A.

Conversely, on this view, there is a GWR problem if B (the settlor) is UK domiciled (regardless of the domicile of A).

45.14 GWR PET charge

So far we have considered the position where the benefit continues until the death of the donor. Section 102(4) FA 1986 provides:

> If, at a time before the end of the relevant period, any property ceases to be property subject to a reservation, the donor shall be treated for the purposes of the 1984 Act as having at that time made a disposition of the property by a disposition which is a potentially exempt transfer.

I refer to this as "**the GWR PET charge**". Section 102(4) is a deeming provision; it is a different deeming from s.102(3), the GWR death charge.

In s.102(3) the donor is deemed to be beneficially entitled. Here, the donor is deemed to have made a PET. To understand the significance of this, it is necessary to set out the definition of a PET. A PET is a particular kind of transfer of value (s.3A IHTA) and s.3 IHTA provides:

> (1) [a]... a transfer of value is a disposition made by a person (the transferor) as a result of which the value of his estate immediately after the disposition is less than it would be but for the disposition; [b] and the amount by which it is less is the value transferred by the transfer.
> (2) For the purposes of subsection (1) above no account shall be taken of the value of excluded property which ceases to form part of a person's estate as a result of a disposition.

Note that s.3(1) contains two definitions: s.3(1)[a] defines "transfer of value" and s.3(1)[b] defines "value transferred". For both purposes s.3(2) states that excluded property is (in short) disregarded.

45.14.1 *Non-settled GWR PET charge*

Suppose:

(1) a non-UK domiciliary makes a non-settled GWR of non-UK situate property; and
(2) the property ceases to be subject to a reservation (while the donor is still non-UK domiciled).

No-one could sensibly suggest that there is a possible IHT charge. The reason is in s.3(2): the donor is deemed to have made a disposition of excluded property. While one can (just) call that a PET, the value transferred is ignored and no charge to IHT can arise. Nothing in the deeming provision requires one to ignore the application of s.3(2) to s.3(1)[b]. What matters is the domicile of the donor (and the situs of the GWR property) at the time the reservation ceases. There would be a deemed PET if:

(1) F (a foreign domiciliary) makes a GWR.
(2) F becomes UK domiciled.

(3) The GWR is released.[26]

45.14.2 *Settled GWR PET charge*

Suppose settled property ceases to be subject to a reservation; e.g. a donor ceases to be a beneficiary of a trust he has created, and becomes excluded from all benefit.

The HMRC view is tentative. IHT Manual 14396 provides:

> **Example**
> The donor, who is domiciled in Australia, puts foreign property into a discretionary trust under which he is a potential beneficiary. He dies five years later domiciled in the UK and without having released the reservation (IHTM14393).
> ...
> **Reservation ceasing during lifetime**
> However, had the donor in the above example attained UK domicile after the gift and then released the reservation during his lifetime, it is *arguable* that the release would have been a PET (IHTM04057), chargeable on the death within seven years. In effect, the property ceased to be excluded property at the time the reservation was released. The release would thus have triggered a charge *which would not have arisen had the release not been made.*[27]
> Refer any case where you consider that there is such a charge, or any enquiries about the possibility of a charge, to Litigation.
>
> (Emphasis added)

But the issues are similar to the case of the GWR death charge: how far do you carry the implications of the deemed PET? Do you deem the GWR property which is actually settled property to be non-settled property? Although the deeming is marginally different, the context is the same as for GWR on death.

The answer must be decided consistently with the answer to the related issue for a GWR on death. If (as argued above) the Settled Property Solution is correct on death then there is also no charge on a lifetime cessation of GWR. If (as some say) the Non-settled Property Solution is

26 There is a hint of this in IHTM 14318, but the point is not addressed clearly.

27 Note these words assume the Settled Property Solution is correct.

correct, the lifetime cessation of GWR also gives rise to tax (if the donor is UK domiciled when the GWR ceases and dies within seven years). What cannot possibly be correct is the view tentatively expressed in the IHT Manual, that there could be a charge on a lifetime cessation but no charge on death.

45.15 GWR on termination of interest in possession

Before 22 March 2006, GWR did not in principle apply on the termination of an interest in possession, because the termination did not usually involve a disposal by way of gift. Now s.102ZA FA 1986 provides:

> **Gifts with reservation: termination of interests in possession**
> (1) Subsection (2) below applies where—
> (a) an individual is beneficially entitled to an interest in possession in settled property,
> (b) either—
> (i) the individual became beneficially entitled to the interest in possession before 22nd March 2006, or
> (ii) the individual became beneficially entitled to the interest in possession on or after 22nd March 2006 and the interest is an immediate post-death interest, a disabled person's interest or a transitional serial interest, and
> (c) the interest in possession comes to an end during the individual's life.
> (2) For the purposes of—
> (a) section 102 above, and
> (b) Schedule 20 to this Act,
> the individual shall be taken (if, or so far as, he would not otherwise be) to dispose, on the coming to an end of the interest in possession, of the no-longer-possessed property[28] by way of gift.

On the termination of an interest in possession, the former life tenant is in the same position as the settlor of the trust. See 45.12 (GWR death charge: excluded property rules for settled property).

28 "The no-longer-possessed property" is defined in s.102ZA(3):
"In subsection (2) above 'the no-longer-possessed property' means the property in which the interest in possession subsisted immediately before it came to an end, other than any of it to which the individual becomes absolutely and beneficially entitled in possession on the coming to an end of the interest in possession."

If the life tenant does not enjoy any GWR, no problem arises.

If the former life tenant does enjoy a benefit the position is thought to be as follows:

(1) The GWR rules do not apply if the GWR property is excluded property.
(2) The GWR property is excluded if:
    (a) the settlor was not UK domiciled when the settlement was made; and
    (b) the trust property is not UK situate (or UK funds excluded property) at the time of the GWR charge (the death of the former life tenant or the time of cessation of benefit).

45.16 GWR property subject to debt

Debts are in principle deductible in computing a GWR charge. HMRC accept this. IHT Manual provides at 14401 [June 2006]:

> *Example*
> In 1990 the donor settles £1 on discretionary trusts of which he is, and remains until his death in 2000, an object. Shortly after the creation of the settlement he advances £50,000 to the trustees by way of loan, interest free and repayable on demand.
> At the time of his death, the settled property comprises £1 cash (representing the original £1 gift into settlement) and the proceeds of an insurance policy (purchased with the borrowed monies) on the donor's life amounting to £250,000.
> The loan of £50,000 has been repaid at the rate of £2,500 per annum by the trustees and £25,000 is outstanding at the date of death.
> The proceeds of £250,000, *less the loan of £25,000,* are derived from the original loan, and you can treat them as part of the death estate. (The balance outstanding under the loan – £25,000 – forms part of the free estate).
>
> (Emphasis added)

45.17 Planning and disclosure

Assume a foreign domiciled individual has made a discretionary settlement under which there is a GWR (he is a beneficiary). The property is not UK situate. The settlor becomes UK domiciled or deemed domiciled. There are three possibilities:

(1) If the view taken in this book is correct, it makes no difference whether the GWR continues until death or is released before death.
(2) If (as some say) the Settled Property Solution is correct, a cessation of benefit is advantageous because, if the settlor survives seven years, the property escapes IHT.
(3) If (as the IHT Manual tentatively suggests):
    (a) there is no GWR death charge, but
    (b) the GWR deemed PET is taxable if the donor dies within seven years,

    then a cessation of benefit is undesirable because it will give rise to a tax charge (in the event of death within seven years) which would otherwise not happen.

In my view the taxpayer should conduct his affairs on the basis of view (1), the Settled Property Solution. If for any reason it is desired to terminate the GWR, the sensible course is to do so. One should not be deterred by the ghost of argument (3) rattling its chains in the IHT Manual.

In each of the cases (1), (2) and (3), the PRs must make disclosure of the relevant facts if form IHT 403 is required. Question D3 on page 2 provides:

> Did the deceased make any gift or any other transfer of value on or after 18 March 1986?

This must be answered "yes" if the deceased has made any gift to a trust on or after 18 March 1986.[29] Form D3 question 1d then asks:

> Did the deceased within 7 years of their death ... cease to have any right to benefit from any assets held in trust or in a settlement?

In the event of a lifetime cessation of benefit within seven years of death

29 The *ejusdem generis* argument that "gift" means only a gift which is a transfer of value is very doubtful. The question must also be answered "yes" if s.102(4) FA 1986 applies, as that is a deemed PET.

the correct answer is, "yes".[30] In the event of GWR on death, question 2c asks:

> Did the deceased transfer, on or after 18 March, any assets during their lifetime but ... did the deceased continue[31] to have some right to benefit from all or part of the asset?

The answer would likewise be, "yes".

The form asks for details of assets and values, but there is no statutory obligation and I suggest it would be appropriate to refuse to give those details on the ground that no IHT charge arises in any event.

45.18 IHT spouse exemption defence to GWR death charge

This section considers whether the IHT spouse exemption can apply on the death of the donor so as to override the GWR death charge.[32]

Suppose:

(1) H makes a gift to S which is a GWR so the gifted property is GWR property.
(2) H dies and leaves his entire estate to his spouse W (and the IHT spouse exemption applies to his estate).

On the death of H the position for the GWR property is governed by s.102(3) FA 1986:

> that property shall be treated for the purposes of the [IHTA] as property to which [H] was beneficially entitled immediately before his death.

The GWR property is not excluded property (even if S is foreign domiciled).[33] So H will in principle be subject to inheritance tax on the GWR property on his death.

The spouse exemption is not available on the death of H to avoid this

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30 The argument that the interest of a beneficiary under a discretionary settlement is not strictly a "right" is fanciful because the context is GWR.

31 In the context this means "continue until death".

32 For other IHT issues see 45.8 (GWR spouse exemption); ? (UK domiciliary married to foreign domiciliary) and 49.2 (IHT spouse exemption on death of a foreign domiciliary).

33 See 45.11 (GWR death charge: excluded property rules for non-settled property).

GWR charge. The IHT spouse exemption provides that the transfer of value deemed to be made on the death of H:

> ... is an exempt transfer to the extent that the value transferred is
> [a] attributable to property which becomes comprised in the estate of the transferor's spouse or civil partner or,
> [b] so far as the value transferred is not so attributable, to the extent that that estate is increased.

This exemption does not apply to the GWR property since it does not become comprised in the estate of W. HMRC agree. The IHT Manual provides:

> **14303 Devolution of GWR property** [June 2006]
> It is important to keep in mind that that the GWR rules are fictitious treatments created only for the purposes of preventing IHT avoidance. They do not affect the **actual devolution of the property in real life, so the gifted property does not actually pass on death under the will or intestacy, neither was any gift actually made at the time the reservation ceased.**
> The gifted property passed to the actual donee at the time it was actually made. Thus, any reliefs or exemptions (IHTM11001) that may be available on death, or that apply to PET's, such as spouse or civil partner relief (IHTM11032), charity relief or annual exemptions, will **not apply to the transfer deemed to be made on death, or deemed to be made when the reservation ceases.**

Suppose:

(1) H (UK domiciled) makes a gift to W (foreign domiciled at the time of the gift).[34]
(2) The gift does not qualify for the IHT spouse (or any other) exemption and H continues to enjoy benefits from the property until his death so the gifted property is GWR property.
(3) W still owns the GWR property at the time of the death of H.
(4) W has become UK domiciled (or deemed domiciled) at the time of the death of H.

34 The gift is a PET (but assume H survives seven years so no tax charge arises on the PET).

At first glance it might seem that the IHT spouse exemption does not apply. On the facts of this example the conditions of the relief are not in reality satisfied. The GWR property does not "become" comprised in the estate of the spouse; and on the occasion of the death of H, the estate of the spouse has not "increased". However, one must remember that s.102(3) FA 1986 is a deeming provision. It is the old question of how far one carries the deeming.[35] If one deems, as s.102(3) requires, the GWR property to be property to which H was beneficially entitled, it would follow that one must deem the estate of W to be increased by reason of the death of H. The conclusion is supported by considering the object of the GWR rules. The object is to put the donor in the same position as if he had not made the gift. If H had not made his gift then (on the facts of the above example) he would qualify for the spouse exemption.

The IHT spouse exemption would also apply to defeat a GWR death charge if H made a gift to a trust under which his spouse acquired an estate interest in possession on his death.

The same would apply if A made a GWR gift to B and A was not married to B at the time of the gift but was married at the time of his death.

45.18.1 *Remedial tax planning where there has been a GWR*

Where H has made a gift to W, and a reservation of benefit problem arises, the following solutions may be considered:

(1) H ceases to enjoy any benefit.
(2) W gives the property back to H.
(3) Arrange that the spouse exemption applies on the death of H. (Not possible if H is UK domiciled and W is not UK domiciled at the time of the death of H.)
(4) W settles the property: see ? (Gift to foreign domiciled spouse, followed by settlement by spouse).

35 See 45.11.1 (Construction of deeming provisions).

CHAPTER FORTY SIX

IHT CONSEQUENCES OF TRANSFERS BETWEEN TRUSTS

46.1 Transfers between trusts – Introduction

This chapter considers the IHT consequences[1] of transfers between trusts and adding property to trusts. There are three main tiers of rules:

(1) General principles of trust law and tax law which apply in the absence of specific IHT provisions.
(2) A specific IHT provision which applies generally for IHT trust taxation: s.44(2) IHTA.
(3) Specific IHT provisions which apply only to IHT relevant property[2] ("RP") taxation: ss.81–82 IHTA.

The main significance of these rules relates to excluded property status, especially if there has been a change of domicile of the settlor. The rules can affect other matters such as the date and computation of a ten-year charge.

For completeness, yet further sets of rules applies to employee trusts[3] (not discussed here) and pension trusts.

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1 For CGT, see 38.17 (Transfer between trusts). Section 731 ITA may need consideration. Another issue (not dealt with here) is that the transfer may be a transfer of value under s.52 IHTA or may give rise to an exit charge under s.65 IHTA.

2 That is, property which is relevant property as defined by s.58 IHTA. Before 2006 this meant discretionary trusts, but (from 22 March 2006) it includes non-estate IP trusts.

3 See s.86(4)(5) IHTA.

46.2 Trust law background

There are several ways by which property can move between settlements (without a person becoming beneficially entitled to the property in the meantime). For the purposes of this chapter the two important ways are as follows:

(1) Trustees may exercise a power to transfer trust property to another trust.[4] (Assume for the purpose of discussion that trustees have such a power; in any particular case the terms of the trust would need to be reviewed. Restrictions on accumulation and perpetuity periods also need consideration.)

(2) (a) A beneficiary who is entitled to a contingent or reversionary interest in the capital of the trust fund of trust A may assign that interest to trust B; and
  (b) the trustees of trust B in due course become absolutely entitled to the trust fund of trust A.

46.3 General tax principles

The general tax principles are discussed elsewhere.[5] The conclusions are as follows:

(1) If trustees exercise a power to transfer property from trust A to trust B, then, at least to the extent of the transferred property, the settlor of trust A is a settlor of trust B.[6]

(2) If a beneficiary with an equitable interest under trust A transfers this interest to trust B, then, at least to the extent of the interest transferred, the beneficiary is a settlor of trust B.

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4 This needs to be distinguished from the situation where trustees exercise a power to vary the terms on which they hold trust property without a transfer to another trust. The distinction is a trust law concept. A discussion is beyond the scope of this book: see *Dymond's Capital Taxes*, 16.230.

5 See 58.7 (Transfer from trust A to trust B by exercise of trustees' power).

6 That is:
  (1) If all the property of trust B is derived from A, directly or indirectly, then A is the only settlor of trust B.
  (2) If some of the property of trust B is derived from A and some from B, then A and B become joint settlors.

46.4 The separate settlements fiction

Section 44(2) IHTA provides:

> Where more than one person is a settlor in relation to a settlement and the circumstances so require, this Part of this Act (except s.48(4) to (6)) shall have effect in relation to it as if the settled property were comprised in separate settlements.

I refer to this as "**the separate settlements fiction**". The fiction is needed because IHT generally assumes that every settlement has one settlor; instead of making provisions for a trust with multiple settlors, the scheme is to regard such trusts as multiple trusts.

IHT Manual para 42253 [June 2007] provides:

> This separation has 3 main effects
> - Where more than one trust exists each will have its own nil-rate band for rate purposes.
> - The value of property may be affected. For example, holdings of unquoted shares in a single trust might amount to a control holding whereas the same parcels of shares would be minority holdings if taken separately.
> - The separate trust made by the second person will have its own starting date. (IHTM42221)

This is correct as far as it goes, but it ignores the foreign domicile aspects of the rule.

The exception for the purposes of s.48(4) to (6) concerns exempt gilts and is not discussed here.[7]

The separate settlements fiction is expressed to apply for the purposes of Part 3 IHTA (not generally), but all the important provisions which govern trust tax are in Part 3.[8]

The words "and the circumstances so require" show that the drafter was aware that the separate settlements fiction would not always be appropriate. It is unfortunate that he did not formulate the circumstances in which this would be the case.

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7 See 44.11 (Trusts: exempt gilts).

8 The separate settlements fiction has to be repeated in s.201(4) IHTA in order to apply it to s.201 (because that is not in Part 3).

When the separate settlements fiction applies, the settled property is treated as being in separate trusts (which I call "**notional trusts**"). It is important to note that these are fictional or notional trusts. They do not exist in the sense that the trust with joint settlors exists. Each notional trust must (for IHT purposes) be regarded as possessing three features: (1) notional trust property (2) a notional settlor and (3) a notional date on which it was made. These features are as notional or fictional as the notional trust itself. The statute does not expressly tell us what they are: context and common sense must fill that gap.

46.5 B adds property to A's trust

Suppose:

(1) an individual ("A") creates a trust ("the real trust"), and
(2) another[9] individual ("B") adds property to it.[10]

The real trust has two settlors, A and B. The separate settlements fiction applies, and one must imagine that the trust fund of the real trust is comprised in two notional trusts, "notional trust A" and "notional trust B". Common sense suggests:

(1) Notional trust A is regarded as if:
  (a) It holds the property given by A.
  (b) A is its sole settlor.
  (c) It was made at the time A made the real trust.
(2) Notional trust B is regarded as if:
  (a) It holds the property given by B.
  (b) B is its sole settlor.
  (c) It was made at the time B added property to the real trust.

It is suggested that the same applies if B adds value indirectly to the real trust (e.g. by a gift to a company held by the real trust). The real trust has

9 For the position where the settlor adds to his *own* trust, see 44.14 (Settlor adds property to trust after change of domicile).
10 The same analysis applies is A and B together transfer funds to a new jointly made trust.

two settlors, A and B.[11] The circumstances require the real trust to be regarded as two separate notional trusts. A division of the trust property of the real trust into two parts representing the value given by A and the value given by B is still possible. It may not be easy but it is no harder than many apportionments required for tax.[12]

46.6 Direct settlor and indirect settlor

Suppose there is an arrangement under which:

(1) A gives property to B, and
(2) B gives the property to a trust ("the real trust").

It appears at first sight that there are then two settlors: an indirect settlor (A) and a direct settlor (B).[13] Both have provided the *same* property.

What is the IHT analysis? On one view the separate settlements fiction applies so that the settled property in the real trust is treated as being comprised in separate trusts (which I call "notional trust A" and "notional trust B"). On this view the consequence is said to be that:

(1) Notional trust A:
    (a) holds *all* the trust property of the real trust;
    (b) A is its sole settlor;
    (c) I do not know when proponents of this view would say that notional trust A was made. It would either be at the time A gave the property to B or the time that B settled it, and this poses perhaps another difficulty with this view.
(2) Notional trust B:
    (a) also holds *all* the trust property of the real trust;
    (b) B is its sole settlor;
    (c) was made at the time B created the real trust.

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11 See 58.14 (Provision of property for company held by trust).

12 For instance, apportionment of gains of non-resident companies to participators.

13 See 58.4 (Gift from A to B followed by gift to trust by B). This issue usually arises in the context of failed tax planning of the kind discussed at 58.34 (Planning to create trust with foreign domiciled settlor).

The difficulty with this view is that it leads to double taxation[14] and the separate settlements fiction which only applies "if the circumstances so require" should not be used to give that result. So the better view is that the circumstances do not "so require" and the separate settlements fiction does not apply.

We have therefore one real settlement with two settlors. What is the position for excluded property if A is foreign domiciled and B is not? It will be recalled that settled property is (in short) excluded property "unless *the settlor* was domiciled in the UK at the time the settlement was made". There are two possible solutions:

(1) One cannot say that "the settlor" was domiciled in the UK unless both settlors were domiciled here. In that case the trust property may be excluded property if either A or B are foreign domiciled.
(2) To read the word "the settlor" in this context as meaning "the settlor or one of the settlors".[15] In that case the trust property is only excluded property if A and B are both foreign domiciled.

Both solutions have anomalous results, though in one case the anomaly favours the taxpayer and in the other it favours HMRC.

The best solution to this conundrum is that one should identify A as the "real" settlor and infer that B should not be regarded as a settlor.[16] Then the problem does not arise.

46.6.1 *The HMRC view*

RI 166 provides:

> **Several persons contribute to a single settlement** [February 1997]
> ...
> [Section 44(2)] is similar in terms to FA 1975 Sch 5 para 1(8), which

14 This view is supported by comments in *Hatton v IRC* [1992] STC 140 at pp.160–161. But (1) the comments are obiter (2) the judge did not have the benefit of counsel's arguments on the issue (3) the judge did not appreciate the double taxation difficulties which arise on his view; in the circumstances it is considered that these comments do not represent the law.

15 Applying (perhaps extending) the rule of construction that the singular includes the plural.

16 See 58.4.2 (If A is indirect settlor is B also the settlor?).

> was considered by Chadwick J in *Hatton v IRC* [1992] STC 140. In the light of the decision in that case [HMRC] take the view
> [1] that the determination of the extent to which overseas assets in a settlement are excluded property by reason of the settlor's domicile is a relevant "required circumstance"; and that
> [2] where a clear, or reasonably sensible, attribution of settled property between the contributions made by several settlors is possible, there will be a separate settlement, with its own attributed assets, for each contributor for IHT purposes;
> [3] if such an attribution is not feasible, each separate settlement will comprise all the assets of the single, actual settlement.[17]
>
> **Trust records**
>
> It follows from the comments above that the trustees of a settlement should keep adequate records to enable any necessary attribution of the settled property to be made if ... two or more persons have contributed funds for the purposes of the settlement.

Point [2] is correct. Point [3] is difficult to apply and doubtful. It is difficult to apply because how does one know whether attribution is "feasible"? I suggest it should always be feasible where two or more persons have contributed funds.[18] Point [3] is doubtful because it rests on shaky obiter comments, discussed above, which was actually considering the different situation of *reciprocal* settlors. I do not wish to consider reciprocal settlors here because they are hardly ever found in practice, but if the Judge's comments are right at all, they should be restricted to the case of reciprocal settlors, where it might more plausibly be said that attribution between settlors is not feasible. RI 166[3] suggests that penal taxation may arise as a result of inadequate record keeping, but that cannot be right.

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17 In similar vein, IHT Manual para 42253 provides:

> "In practice, you can take the phrase 'and the circumstances so require' to mean, 'in a simple and straightforward case'.
> [1] You can accept the separateness of direct additions made by the settlor's favourite aunt,
> [2] but if for instance the added property is situate in Liechtenstein and transferred by a nominee in Liberia to a trust company in Jersey you would need to satisfy yourself as to what the circumstances were and whether they require treatment as separate trusts."

Para [2] unhelpfully ducks the issue.

18 This is assumed in s.471 ITA; see 58.7.3 (IT and CGT rule).

In practice it is perhaps better to avoid joint settlors (or for one person to add property to a settlement made by another). This avoids the complication of the separate settlements fiction. But in a straightforward case there should not be any difficulty as long as:

(1) both settlors are foreign domiciled; or
(2) one settlor is UK domiciled, but trust record keeping is adequate.

It is likewise best to avoid indirect additions to a trust fund (e.g. a beneficiary using his own funds to improve trust property), where the original settlor is foreign domiciled and the person adding property is UK domiciled. If the settlor adds property to a trust of which he is the settlor, this problem does not arise.[19]

46.7 Transfer from trust made by A to trust made by B

Suppose:

(1) A gives property ("A's fund") to trust A ("real trust A").
(2) B gives property ("B's fund") to trust B ("real trust B").
(3) The trustees of real trust A transfer A's fund to real trust B.[20]

Real trust B has two settlors, A and B. The separate settlements fiction applies and one imagines that the settled property is comprised in two notional trusts ("notional trust A" and "notional trust B"). Notional trust A is regarded as if:

(1) it holds the property provided by A;
(2) A is its sole settlor;
(3) The important question is: at what time is notional trust A regarded as being made? The choice is:
    (a) at the time that real trust A was made;
    (b) at the time of the transfer to real trust B.

The latter view cannot be right, for various anomalies would then arise.

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19 See 44.14 (Settlor adds property to trust after change of domicile).
20 The same analysis applies if the trustees of real trusts A and B transfer both trust funds to a third real trust C.

(1) Suppose A died before the transfer to real trust B. One cannot then apply the rule that the excluded property status of the trust depends on the domicile of the settlor "at the time the settlement was made."[21]

(2) Suppose a transfer from trust A to trust B and A changes domicile after the date of trust A but before the transfer:
   (a) If A is UK domiciled when he made real trust A and foreign domiciled at the time of the transfer to real trust B, A's fund would become excluded property after the transfer. One cannot expect HMRC to agree with that.
   (b) Conversely, if A is foreign domiciled when he made real trust A and UK domiciled at the time of the transfer to real trust B, the trust fund would cease to be excluded property.

   These are not equivalent or self cancelling anomalies, for in case (a) no transfers would usually take place, whereas in case (b) transfers would take place every time.

Under my analysis, there is in principle no IHT advantage or disadvantage from a transfer to another trust, regardless of changes in the settlor's domicile, or the settlor's death, which is logical and sensible. I see no difficulty in a rule that the notional trust is regarded as made before the transfer, for once one accepts that the notional trust is fictional, it can logically be regarded as being made on any date.

This view is also consistent with the principle in *Muir v Muir* [1943] AC 468.

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21 It has been argued that if A is UK domiciled when he made real trust A and dead at the time of the transfer to real trust B, A's fund can be excluded property after the transfer. The argument is:
(1) Notional trust A is regarded as made at the time of the transfer to real trust B.
(2) A is regarded as not "domiciled in the UK" at that time (because a dead person has no domicile).
The view that notional trust A is regarded as made at the time real trust A was made avoids obvious anomalies and is to be preferred.
If (contrary to my view) notional trust A is regarded as made at the time of the transfer to real trust B, after the death of A, one might regard A as having at that time the domicile he had:
(1) at the time of his death; or
(2) at the time he made real trust A.
Another view is that s.44(2) only applies if the circumstances so require, and they do not so require, However adopting my approach, s.44(2) gives a sensible result.

46.8 Transfer from trust made by A to another trust made by A

Now suppose:

(1) A creates two separate trusts, trust A1 and A2.
(2) The trustees of trust A1 transfer property ("the transferred property") to trust A2.

Trust A2 has only one settlor, A, and the separate settlements fiction does not apply to it. The possibilities are as follows:

A is UK domiciled when he made trust A1 but not when he made trust A2. It is suggested that the transferred property in trust A2 may in principle[22] qualify as excluded property. Trust A2 *does* satisfy the condition that the settlor was foreign domiciled at the time that *this* settlement was made.

A is foreign domiciled when he made trust A1 and UK domiciled when he made trust A2. The result is reversed. The transferred property in trust A2 is not excluded property. Trust A2 does not satisfy the condition that the settlor was foreign domiciled when this settlement was made.

Thus there is a distinction between:

(1) transfer from trust made by A to a trust made by B (change of A's domicile irrelevant); and
(2) transfer from trust made by A to another trust made by A (change of A's domicile significant).

This is anomalous but the anomaly naturally follows from the fact that the separate settlements fiction applies in case (1) and not in case (2).

46.8.1 *Transfer from trust made by A to empty trust*

It is tentatively suggested that the same applies where trustees of trust A1 transfer the trust fund to new trustees who hold on the terms of a new declaration of trust which is an "empty trust", there being no trust property

22 S.81 IHTA needs to be considered: see 46.9 (The same settlement fiction: s.81).

before the transfer ("trust A2"). In this case too the separate settlements fiction does not apply.

The view that trust A2 is regarded as made at the time trust A1 was made, applying the principle of *Muir v Muir* [1943] AC 468, gives a sensible result but is hard to reconcile with s.60 IHTA which provides:

> In this Chapter references to the commencement of a settlement are references to the time when property first becomes comprised in it.

It is considered that the transferred property may in principle[23] be excluded property if A is living and foreign domiciled at the time of the transfer, even though A was UK domiciled when he made trust A1.

What if A is dead at the time of the transfer? On a literal reading, one might argue that (regardless of the domicile of A during his life) the settlor A was not UK domiciled when trust A2 was made, since a deceased person has no domicile. The scope for tax avoidance would make that result unacceptable to a court in a case where A was UK domiciled at the time he made trust A1 and at the time of his death. A court is likely to regard A as retaining after his death the domicile he had during his life. This is not as much of a stretch as first appears. If a company can be regarded as having a domicile (by analogy to the domicile rules of a living individual) why not a deceased person? However, it is suggested that the trust property in trust A2 may be excluded property if A was not UK domiciled at the time of his death.

46.9 The same settlement fiction: section 81

Section 81(1) IHTA provides:

> **Property moving between settlements**
> Where property which ceases to be comprised in one settlement becomes comprised in another then, unless in the meantime any person becomes beneficially entitled to the property (and not merely to an interest in possession in the property), it shall for the purposes of this Chapter[24] be treated as remaining comprised in the first settlement.

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23 See fn 18.

24 "This Chapter" is Chapter 3 Part 3 IHTA which deals with relevant property trusts.

I call this "**the same settlement fiction**".

What is the purpose of the same settlement fiction? It must be intended to counter tax avoidance based on moving property between settlements. A simple example arises where a trust is approaching its 10-year anniversary. The trustees might transfer the trust property to another discretionary trust, whose 10-year anniversary is many years ahead. Alternatively they might appoint an interest to a beneficiary who transfers that interest to a new trust (which then becomes entitled to the trust property). This might avoid the 10-year charge on the first trust. Section 81 neatly counteracts both these by deeming the property to remain in the first trust. This explains why the same settlement fiction applies only for the purpose of IHT relevant property trust taxation.

IHT regards trust property as a continuing fund, so s.81 clearly does not apply on a sale between trusts at full value, for no property moves between settlements.

Section 81 does not apply to a loan from trust 1 to trust 2 on commercial terms. It does not apply to an interest free loan repayable on demand, because the promise to repay is full consideration.

The section only applies on a transfer of trust capital: if trustees of a discretionary trust distribute trust income to another trust, it is suggested that s.81 does not apply, because the income is not "settled property".

46.9.1 *Section 81: excluded property rule*

Where s.81 applies, s.82 IHTA imposes an additional condition for trust property to qualify as excluded property. This provides:

> **Excluded property**
> (1) For the purposes of this Chapter ... property to which section ... 81 above applies shall not be taken to be excluded property by virtue of section 48(3)(a) above unless the condition in subsection (3) below is satisfied (in addition to the conditions in section 48(3) that the property is situated outside the UK and that the settlor was not domiciled there when the settlement was made).
> (2) [This contains a transitional rule: see 46.9.7 (s.81 transitional rules).]
> (3) The condition referred to in subsection (1) ... above is ...
> (b) in the case of property to which subsection (1) or (2) of section 81 above applies, that the person who is the settlor in relation to the second of the settlements mentioned in the subsection concerned,

was not domiciled in the UK when that settlement was made.

This rule only applies in determining whether foreign situate property is excluded property, so it does not apply for AUTs and OEICs.[25] Since this rule only applies for the purposes of relevant property trust taxation, one must distinguish:

(1) excluded property for the purposes of relevant property trust tax ("RP excluded property"); and
(2) excluded property for other IHT purposes.

The consequences of s.82(3)(b) depend on the circumstances of the transfer.

46.9.2 *Transfer from trust made by A to another trust made by A*

Suppose:

(1) A creates two separate trusts, trust A1 and trust A2.
(2) The trustees of trust A1 transfer property ("the transferred property") to trust A2.

The possibilities are as follows:

A is not UK domiciled when he made trust A1 but UK domiciled when he made trust A2. The transferred property in trust A2 is not excluded property under general IHT principles.[26]

A is UK domiciled when he made trust A1 but not UK domiciled when he made trust A2. The transferred property may be excluded property under general IHT principles. However, s.82 prevents foreign situate transferred property in trust A2 from qualifying as RP excluded property. (This is probably an accidental consequence of the wording, because if the drafter had had the point in mind he would have made s.82 IHTA apply for all IHT purposes and not only for the purposes of relevant property trust taxation.)

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25 See 44.9 (Trusts: authorised unit trusts and OEICs).
26 See 46.9.5 (B transfers equitable interest to another settlement).

In short, for foreign situate transferred property to qualify as RP excluded property, A must be domiciled outside the UK at the time he made trust A1 and trust A2.

46.9.3 *Transfer on to third trust*

Suppose:

(1) A creates three separate trusts, A1, A2 and A3.
(2) The trustees of trust A1 transfer property ("the transferred property") to trust A2.
(3) The trustees of trust A2 transfer the transferred property to trust A3.

The transferred property is treated as remaining in trust A1. It is only excluded property if A was not UK domiciled when he made "the second of the settlements mentioned" in s.81(1), but that refers (it is considered) to trust 3. The domicile of A at the time he made trust A2 is not relevant.

Thus if trustees of an excluded property trust transfer property to a non-excluded property trust made by the same settlor, they have fallen into a trap: foreign situate transferred property ceases to be excluded property.[27] But they can extricate themselves from the trap if the trustees of trust A2 transfer the property back to trust A1; or if they transfer it on to trust A3 (if A3 is a trust made when the settlor is not UK domiciled).

46.9.4 *Transfer from trust made by A to trust made by B*

Suppose:

(1) A gives property ("A's fund") to a settlement ("real trust A").
(2) B gives property ("B's fund") to a separate settlement ("trust B").
(3) The trustees of real trust A transfer A's fund to trust B.

For general IHT purposes, A's fund is regarded as in a notional trust and may be excluded property if A was not UK domiciled when real trust A was made.[28] At first sight the position for the purposes of RP trust tax

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27 If this was unforeseen, the transfer might well be invalid under the rule in *Hastings-Bass*.

28 See 46.7 (Transfer from trust made by A to trust made by B).

seems to be different:

(1) A's fund is treated as remaining comprised in real trust A (applying the same settlement fiction); and
(2) foreign situate property in A's fund can only be excluded property if:
(a) A is foreign domiciled at the time real trust A was made; and
(b) B is foreign domiciled at the time trust B was made

(applying the s.82 rule).

There is a better view. On these facts the separate settlements fiction of s.44(2) applies. A's fund is treated for IHT as if it were transferred to a separate notional trust. The same settlement fiction applies as if there is a transfer from real trust A to the separate notional trust deemed to be made by A at the time (I think) of real trust A. So, for RP trust tax purposes, A's fund may be excluded property if A is not UK domiciled at the time he made trust A. That is, the s.82 rule does not add anything to the general excluded property rule. The domicile of B is irrelevant. That gives a fair result and is consistent with what I take to be the purpose of s.82; see below.

A similar result applies if the transfer is to a company held by trust B.

46.9.5 *B transfers equitable interest to another settlement*

The position is different if:

(1) A gives property ("A's fund") to a settlement ("trust A").
(2) B has an equitable interest under trust A (perhaps a reversionary or contingent right to trust capital).
(3) B assigns his equitable interest to a separate settlement ("trust B").
(4) Trust B becomes entitled to A's fund (perhaps because the reversionary interest falls into possession or the contingency is satisfied).

B is in principle the settlor of trust B for general tax purposes. The position for the purposes of RP trust taxation is that:

(1) A's fund is treated as remaining in trust A (applying the same settlement fiction); and

(2) A's fund can only be RP excluded property if:
(a) A is foreign domiciled at the time that trust A was made, and
(b) B is foreign domiciled at the time trust B was made

(applying the s.82 rule).

It would be possible to avoid these consequences if the trustees of trust B sell the equitable interest before it falls into possession, or if they transfer it to a company.

46.9.6 *Purpose of section 82(3)(b)*

What is the purpose of s.82(3)(b)? Dymond explains:

> Section 82 is designed to prevent the avoidance of tax by exploitation of ss 80 and 81. Suppose, for example, that:
> [1] *A*, who is domiciled outside the UK, settles foreign property on discretionary trusts for a short period with remainder to himself.
> [2] *B* buys *A*'s reversion after 9 December 1981 and settles it on discretionary trusts.[29]
> Under s 81 the property is treated as remaining comprised in *A*'s settlement, and apart from s 82 it would be excluded property and not liable to tax. Under s 82 it is *not* taken to be excluded property unless *B* also was domiciled outside the United Kingdom when he made his settlement.[30]

Under the general law, B would in principle be the settlor of trust B, but applying the same settlement fiction, A would be the settlor! Section 82 counteracts this tax advantage. If my analysis is right,[31] then s.82 works quite neatly.

An incidental result is to restrict or prevent tax advantages on a transfer from trust A1 to A2 where A was UK domiciled when he made trust A1 but foreign domiciled at the time he made trust A2.[32]

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29 These are the facts considered in 46.9.5 (B transfers equitable interest to another settlement).
30 *Dymond's Capital Taxes*, 19.810.
31 See 46.9.4 (Transfer from trust made by A to trust made by B).
32 See 46.9.2 (Transfer from trust made by A to another trust made by A).

46.9.7 *Section 81 transitional rules*

Section 81(2), (3) IHTA sets out three transitional rules:

> (2) Subsection (1) above shall not apply where the property ceased to be comprised in the first settlement before 10 December 1981; but where property ceased to be comprised in one settlement before 10 December 1981 and after 26 March 1974 and, by the same disposition, became comprised in another settlement, it shall for the purposes of this Chapter be treated as remaining comprised in the first settlement.
>
> (3) Subsection (1) above shall not apply where a reversionary interest in the property expectant on the termination of a qualifying interest in possession subsisting under the first settlement was settled on the trusts of the other settlement before 10 December 1981.

46.10 Pension benefits

Lastly, for completeness, there is a special rule for pension benefits. Section 151(5) IHTA provides:

> Where a benefit has become payable under a registered pension scheme a qualifying non-UK pension scheme or a or section 615(3) scheme, and the benefit becomes comprised in a settlement made by a person other than the person entitled to the benefit, the settlement shall for the purposes of this Act be treated as made by the person so entitled.

This is not discussed here.

CHAPTER FORTY SEVEN

IHT DEDUCTION FOR DEBTS

47.1 IHT deduction for debts – Introduction

This chapter is concerned with IHT deductions for debts.[1] One could write a short book on this important and misunderstood topic. This chapter sets out basic principles and their application to foreign domiciliaries. There is some fascinating material in the IHT Manual which is not discussed here.

47.2 Liability of individual

Section 5(3) IHTA provides the authority for deducting an individual's liabilities (or so one might think):

> In determining the value of a person's estate at any time his liabilities at that time shall be taken into account, except as otherwise provided by this Act.

In *Green v IRC* the judge regarded s.5(3) IHTA as merely confirming a

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1 When dealing with debts it may also be necessary to consider other issues:
(1) whether the benefit of debt is a UK situate asset, relevant for CGT and IHT position of the owner of the debt; see 59.1 Concepts of situs);
(2) whether interest on the debt has a UK source, relevant for:
(a) the recipient of the interest who may suffer UK income tax; and
(b) the payor, who may be required to deduct tax;
see 11.11 (Interest: charge and location of source?) and 29.1 (Withholding tax – Introduction).
Consistent with the patchwork nature of UK tax law, different (though overlapping) considerations apply in these contexts.

deduction, not authorising it,[2] but that does not ultimately matter.[3]

The general rule has seven exceptions. The first is in s.5(5) IHTA which provides:

> Except in the case of a liability imposed by law, a liability incurred by a transferor shall be taken into account only to the extent that it was incurred for a consideration in money or money's worth.

This does not often apply, because liabilities are normally incurred for full consideration.[4] In particular, if an individual borrows money, the liability to repay the lender is in principle outside the scope of s.5(5), because it is a debt incurred for full consideration. By contrast, if an individual gratuitously covenants to pay money to a person, his liability to pay under that covenant is not taken into account for IHT.

Section 162(1) IHTA provides a second, self-explanatory exception:

> A liability in respect of which there is a right to reimbursement shall be taken into account only to the extent (if any) that reimbursement cannot reasonably be expected to be obtained.

The third exception, mentioned only for completeness, relates to "any liability arising under or in connection with a policy of life insurance"; see s.103(7) FA 1986. The fourth exception applies if the debt is trust

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2 [2005] STC 288 "... the property of the deceased ... is his personal estate net of his liabilities. In other words, it is at that stage that the liabilities are dealt with. It is not necessary for section 5(3) to provide for a second time that the debts are to be deducted in arriving at the value of the deceased's property (or estate) and in my view it is not really doing that. It is in part confirmatory, but in the main it is intended to provide a qualification or qualifications to the principle that debts are deductible– the meat of the subsection is in the closing words "except as otherwise provided by this Act". One finds provisions in the Act which qualify that right in sections 5(4), 5(5) and 162. Its confirmatory nature is supported by the use of the phrase 'taken into account', which is more general than 'shall be deducted'. I accept that the nature of section 5(3) would be clearer without the comma, but nevertheless it seems to me to be clear enough."

3 The judge construed the section this way in order to reach his (sensible) conclusion that an individual's debt is not allowable against trust funds. However, there were other ways to reach that result.

4 For a discussion of the meaning of "consideration" in tax legislation, see *Taxation of Charities* Kessler & Brown, Key Haven, 7th ed., 2009 para 21.5 (Meaning of 'consideration').

property to which the debtor is treated as entitled as life tenant.[5] The fifth exception applies if the debt is property to which the debtor is treated as entitled under the GWR rules.[6] The sixth (arguable) exception relates to liabilities on non-residents overdrawn foreign currency bank accounts.[7]

A liability is in principle deductible even though it is owed to a connected person. But in this case s.103 FA 1986 will sometimes apply.

47.3 Section 103 FA 1986

The last and most important restriction on deducting debts for IHT is the anti-avoidance provision in s.103 FA 1986. This applies (in short) where an individual owes a debt to a person to whom he has previously made a gift.

The section was described in *McDougal v IRC* 31 ATC 153 as "intricate and involved in expression". The reader who studies this chapter will agree! But if one works patiently through it a few times the meaning becomes clearer; contrast the less convoluted but hopelessly vague wording of s.102.

Section 103 must be split up into separate parts in order to distil the sense:

> **Treatment of certain debts and incumbrances**
>
> (1) Subject to subsection (2) below, if, in determining the value of a person's estate immediately before his death, account would be taken, apart from this subsection, of a liability consisting of
>
> [i] a debt incurred by him or
>
> [ii] an incumbrance created by a disposition made by him,
>
> that liability shall be subject to abatement to an extent ...

Thus, subject to certain defences, s.103(1) disallows the deduction for the liability to a certain extent. The section then goes on to explain the extent of the disallowance:

> ... to an extent proportionate to the value of any of the consideration given for the debt or incumbrance which consisted of—

5 See 47.7 (Debt from life tenant to estate IP trust).

6 See 47.8 (Debt subject to GWR).

7 See 44.19.3 (Overdrawn account).

(a) property derived from the deceased; or
(b) consideration (not being property derived from the deceased) given by any person who was at any time entitled to, or amongst whose resources there was at any time included, any property derived from the deceased.

Thus s.103(1) works like this:

(1) One needs to identify the consideration given for the liability.
(2) One asks to what extent the consideration consists of the type of consideration described in s.103(1)(a) and (b).
(3) To that extent the consideration is in principle disallowed. (There are defences. I will come to those later.)

47.3.1 *Section 103(1)(a) disallowance*

One needs first of all to ascertain whether the consideration for the liability was "property derived from the deceased". If so, the liability is disallowed under s.103(1)(a). The liability is wholly disallowed if all the consideration is "property derived from the deceased" or partly disallowed if the consideration is partly "property derived from the deceased".

The expression "property derived from the deceased" is given a commonsense definition in s.103(3):

> In subsections (1) and (2) above "property derived from the deceased" means, subject to subsection (4) below,
> [a] any property which was the subject matter of a disposition made by the deceased, either by himself alone or in concert or by arrangement with any other person or
> [b] which represented any of the subject matter of such a disposition, whether directly or indirectly, and whether by virtue of one or more intermediate dispositions.

The IHT Manual gives this simple example at 28365:

> **Example**
> On 19 March 1987 A gives his brother B £25,000.

> On 25 April 1987 A borrows back from B £25,000.[8]
> On 7 April 1994 A dies.
> Without the legislation A's estate contains the original £25,000. But if the money were still owing when A died the debt might be claimed as a deduction against his estate. And the PET in 1987 is exempt as more than seven years have elapsed.
> The legislation disallows the deduction for IHT purposes ...

The IHT Manual at 28367 explains "property derived from the deceased":

> In practice, income from property given absolutely by the deceased is treated as falling outside the above definition [contained in s.103(3)]. But where the deceased settled the property, the definition includes income payable under the disposition.
> You should treat money raised by the sale or mortgage of property derived from the deceased as though it was property derived from the deceased.

47.3.2 *Section 103(1)(b) disallowance*

Assuming one passes unscathed past the s.103(1)(a) disallowance, the journey takes us to s.103(1)(b). One must identify the person who gave the consideration for the liability. One then asks whether this is a person:

> who was at any time entitled to, or amongst whose resources there was at any time included, any property derived from the deceased.

If so, the liability is disallowed under s.103(1)(b). In principle the liability is wholly disallowed.[9] The IHT Manual gives this simple example at 28366:

> On 19 March 1987 A gives his brother B a parcel of land worth £25,000.
> On 25 April 1987 A borrows £25,000 from B.
> On 7 April 1994 A dies, at which time B retains the land which is non-

8 [Author's Note] It is assumed that this £25,000 is, or represents, the £25,000 given to B.

9 Unless the consideration for the debt is given by more than one person (very unusual); but see below on defences to the s.103(1)(b) disallowance.

income producing.
The PET has dropped out of cumulation so that no claim arises on the death. As the consideration for the debt was not derived from the deceased s.103(1)(a) FA 1986 would be ineffective.[10] But this arrangement is caught by s.103(1)(b) FA 1986 and the liability is not an allowable deduction for IHT purposes.

47.3.3 *The section 103(2) defences to section 103(1)(b)*

Section 103(2) offers defences to the s.103(1)(b) disallowance.[11] This provides:

> If, in a case where the whole or a part of the consideration given for a debt or incumbrance consisted of such consideration as is mentioned in subsection (1)(b) above, it is shown that
> [a] the value of the consideration given, or of that part thereof, as the case may be, exceeded
> [b] that which could have been rendered available by application of all the property derived from the deceased,
> [c] other than such (if any) of that property—
> (a) as is included in the consideration given, or
> (b) as to which it is shown that the disposition of which it, or the property which it represented, was the subject matter was not made with reference to, or with a view to enabling or facilitating, the giving of the consideration or the recoupment in any manner of the cost thereof,
> no abatement shall be made under subsection (1) above in respect of the excess.

It is helpful to consider this as three distinct defences.

47.3.4 *The s.103(2)[b] defence*

"The s.103(2)[b] defence" is my term for the defence given by the words of s.103(2) down to the end of s.103(2)[b], i.e. ignoring s.103(2)[c].
The IHT Manual gives a simple example:

10 [Author's Note] It is assumed that the £25,000 which B lends to A does not represent the land.

11 Section 103(2) does not override the s.103(1)(a) disallowance.

IHTM28369 - Allowing part of a debt under s.103(2) FA 1986
Even if an arrangement (IHTM28366) is caught by s.103(1)(b) FA 1986, a deduction may be allowed for part of the debt. The debt will not be reduced to the extent that the value of the consideration given by the [lender][12] exceeded what would have been made possible had the lender applied all the property derived from the deceased.
Example
A gives his son B shares worth £20,000.
B lends A, out of his separate resources, £25,000 at a time when the shares were worth £17,000.
A dies and a deduction of £25,000 is claimed.
The value in point is the realisable value at the time the debt was created. So the liability is reduced by £17,000 leaving £8,000 as a valid deduction.

The s.103(2)[b] defence makes the s.103(1)(b) disallowance apply only to the extent that the debt exceeds the value of the property derived from the deceased. That is obviously fair.

47.3.5 *The s.103(2)[c](a) defence*

The next defence is the extension of s.103(2)[b] by s.103(2)[c](a). This prevents double counting with the s.103(1)(a) disallowance. The IHT Manual gives an example at 28369:

> A gives shares worth £15,000 to B
> 18 months later B sells half the shares back to A for £7,500 – which is not paid but left as a debt repayable on demand.
> B lends A £12,000 entirely from his own resources.
> A dies owing B £19,500 [i.e. both debts remain outstanding].

The £7,500 debt is disallowed under s.103(1)(a). The reason is that the consideration for the £7,500 debt (the shares) is property derived from the deceased. The Manual correctly makes this point, thought it uses a sloppy paraphrase of the statutory language:

> The debt of £7,500 is clearly referable to the earlier gift of shares – and falls within s.103(1)(a) FA 1986. This liability is not deductible.

12 The IHT Manual erroneously reads: "deceased".

The Manual then turns to the £12,000 debt:

> Were it not for the provisions of s.103(2)(a) FA 1986 it would be possible to take into account that £7,500 in considering the debt of £12,000. The result would be that the entire debt of £12,000 would be non-deductible, meaning that the whole of the claimed £19,500 would be disallowed. But because under s.103(1)(b) FA 1986 half the value of the shares is included in the consideration given for the debt there remains an excess of £4,500. This figure of £4,500 for the allowable debt is arrived at by calculating the resources available to B against the second loan of £12,000 as £7,500, being the original gift of shares less the £7,500 disallowed. So the balance of £4,500 is deductible without restriction because under s.103(2)(a) FA 1986[13] this amount is the excess consideration.

47.3.6 *The section 103(2)[c](b) defence*

The s.103(2)[c](b) defence is the extension of s.103(2)[b] by sub-para [c](b). The Manual does not give an example of a defence within s.103(2)[c](b); though this is perhaps the most important of the three. The result in the s.103(1)(b) examples in the IHT Manual would be different if the gift from A to B was not made (in short) with a view to enabling B to lend to A.

47.3.7 *The section 103(4) defence*

Section 103(4) provides an important defence to the s.103(1)(a) and (b) disallowances:

> If
> [a] the disposition first-mentioned in subsection (3) above[14] was not a transfer of value and
> [b] it is shown that the disposition was not part of associated operations which included—
> (a) a disposition by the deceased, either alone or in concert or by arrangement with any other person, otherwise than for full

13 The Manual wrongly refers to s.103(2)(a) IHTA 1984.

14 That is, the disposition made by the deceased. See 47.3.1 (Section 103(1)(a) disallowance).

> consideration in money or money's worth paid to the deceased for his own use or benefit; or
> (b) a disposition by any other person operating to reduce the value of the property of the deceased,
>
> that first-mentioned disposition shall be left out of account for the purposes of subsections (1) to (3) above.

Suppose:

(1) S (not UK domiciled) transfers excluded property (i.e. non-UK situate property) to a trust.
(2) S borrows from the trustees and retains or spends the sum borrowed.

At first sight, the debt is disallowed as the consideration is property derived from the deceased, S. However, the s.103(4) defence applies. The disposition to the trust is disregarded, because it is the disposition first-mentioned in s.103(3)[a] and:

[a] the disposition is not a transfer of value;

[b] the disposition is a simple gift. It is not part of associated operations within s.103(4)[b](a) or (b).

Thus a debt to an excluded property trust is not disallowed under s.103. The same applies if the gift is to a trust where the settlor has a estate IP (e.g. a gift to an IP trust before 22 March 2006) because such a gift is not a transfer of value.

Suppose:

(1) The trustees lend to the settlor, S.
(2) S gives the borrowed money to a trust.

In this case the debt is disallowed. The s.103(4) defence does not apply. Condition [a] is satisfied but condition [b] is not, because the gift to the trust is an associated operation.

47.3.8 *Section 103(5) deemed PET*

Section 103(5) FA 1986 provides:

> If, before a person's death but on or after 18 March 1986, money or money's worth, is paid or applied by him—
>
> (a) in or towards the satisfaction or discharge of a debt or incumbrance in the case of which subsection (1) above would have effect on his death if the debt or incumbrance had not been satisfied or discharged, or
>
> (b) in reduction of a debt or incumbrance in the case of which that subsection has effect on his death,
>
> the [IHTA] shall have effect as if, at the time of the payment or application, the person concerned had made a transfer of value equal to the money or money's worth and that transfer were a potentially exempt transfer.

There is no express exemption for a foreign domiciliary. However, the principle of territorial limitation requires that some exemption is implied. The best solution is that the deemed PET should be regarded as not only "equal to the money or money's worth" but made out of the money or money's worth. Thus, if the individual is not UK domiciled at the time he repays the debt, *and* the debt is repaid out of excluded property, then no tax charge arises. This would be broadly consistent with the similar provision in section 102(4) FA 1986.[15]

47.3.9 *Assignment of debts*

Suppose:

(1) A borrows from a bank.
(2) B purchases the debt from the commercial lender for its market value.

It is suggested that the purchase price paid by B to the bank is "consideration given for the debt". So A's liability is disallowed if the purchase price which B pays to the bank is property derived from A. Otherwise the section is easy to avoid.

Conversely if A's debt is disallowable because it is made in consideration of property derived from A, it continues to be disallowed even if the debt is sold to a third party. In other words, "consideration for the debt" means the consideration for the creation of the debt but also

15 See 45.14 (GWR PET charge).

includes consideration for the assignment of the debt.

47.3.10 *Section 103 transitional rules*

Section 103(6) FA 1986 provides:

> Any reference in this section to a debt incurred is a reference to a debt incurred on or after 18 March 1986 and any reference to an incumbrance created by a disposition is a reference to an incumbrance created by a disposition made on or after that date …

47.4 The amount of deduction for a debt

Section 162(2) IHTA provides:

> Subject to subsection (3) below, where a liability falls to be discharged after the time at which it is to be taken into account it shall be valued as at the time at which it is to be taken into account.

This only states expressly what one would have expected in any event.

47.5 Deduction for debt of foreign domiciled individual

A UK domiciled individual will not usually mind whether a deduction for his liabilities is set against UK or foreign property as it is usually all subject to IHT.

Suppose a foreign domiciled person with a liability that is deductible for IHT has:

(1) UK situate (non-excluded) property; and
(2) excluded property.

From which property is the deduction for the debt made? If it is made from the excluded property the deduction is wasted.

47.5.1 *Debt is incumbrance*

Section 162(4) IHTA provides:

> A liability which is an incumbrance on any property shall, so far as possible, be taken to reduce the value of that property.

If a liability is an incumbrance on both UK and non-UK assets there must be an apportionment. If the incumbrance on the UK assets has priority, then the deduction should be against that property first.

If it is desired to secure a liability on non-UK property (but to keep the IHT deduction against UK property), a back-to-back guarantee may be a solution. That is:

(1) T borrows from a third party ("the primary liability").
(2) T's primary liability is guaranteed by a bank.
(3) Under the terms of the guarantee, T is required to reimburse the bank if the guarantee is called upon ("the second liability"). This second liability is secured on foreign assets.

Section 162(4) will not apply to the primary liability, which can in principle be deducted from UK property. But watch *Furniss v Dawson*.

Conversely, if on those facts the second liability is secured on UK property, the primary liability is not secured on that property and the deduction is not set against that property.

Note the need to comply with the Bills of Sale Acts if securing loans on chattels.

47.5.2 *Debt not an incumbrance*

Section 162(5) IHTA provides:

> Where a liability taken into account is a liability to a person resident outside the UK which neither—
> (a) falls to be discharged in the UK, nor
> (b) is an incumbrance on property in the UK,
> it shall, so far as possible, be taken to reduce the value of property outside the UK.

This identifies three connecting factors. Where a debt is not an incumbrance on any property, there are two connecting factors and four possibilities:

Case No.	**1**	**2**	**3**	**4**
Liability to UK resident	No	No	Yes	Yes
Discharge out of the UK	No	Yes	No	Yes

Section 162(5) tells us the answer to Case 1: the debt is set against non-UK property. There is nothing about Cases 2 to 4. However, the implication is that in Cases 2 to 4 the debt reduces the value of the property in the UK.

What is the priority between s.162(4) and (5)? It is considered that (4) is applied first. A liability which is an incumbrance on any property is so far as possible to be taken to reduce the value of that property. Only if it is not an incumbrance on any property, or if the amount of the liability exceeds the value of the property, does one apply the rules in s.162(5). The IHT Manual shows that HMRC accept this:

> **28395 - Deducting liabilities where there is excluded property**
> You will see cases where there is excluded property in the estate and deductions may be properly payable out of both excluded and other property. In this situation, provided the debts are to UK creditors, you may allow a deduction in full against the non-excluded property.
> But, in view of s.162(4) IHTA 1984 this does not apply to debts that are charged on excluded property.

47.5.3 *Where does debt fall to be discharged?*

In outline, the place where a liability falls to be discharged is that specified in the contract, or (if not specified) the residence of the creditor.[16] The IHT Manual shows that HMRC broadly accept this:

> **28396 - Deducting UK debts when there is both UK and foreign property in the estate**
> If the deceased's estate includes both UK and foreign assets you should first deduct any UK debts against the UK assets and the deficiency, if any, against the foreign assets. Debts are UK debts if one of the following applies

16 See *Chitty on Contracts*, 29th ed, 2004 para 21-054 (Place of payment). Further consideration is needed for a contract not governed by English law.

- *they are owed to creditors resident solely in the UK*
- they are charged on property in the UK, or
- *they are contracted to be paid in the UK.* ...

(Emphasis added)

A debt which is set against UK property (but which is not charged on specific property) will be set against UK property rateably. Some of the deduction will be wasted if the individual owns UK property outside the scope of IHT: property qualifying for APR or BPR, UK AUTs or OEICs, or exempt gilts.

47.5.4 *Conclusion*

It should be possible to arrange that a debt of a foreign domiciliary is in principle fully deductible against non-excluded property. This can be done without making the debt UK situate but it may give interest on the debt a UK source for income tax.

47.6 Individual[17] borrows and acquires excluded property

Suppose F is not UK domiciled and owns UK situate property worth £1m. He faces an IHT charge on that amount on his death.

F borrows £1m charged on the UK property and deposits that sum outside the UK ("the offshore deposit").

The value of his UK situate property is reduced by £1m and the value of his excluded property is increased by £1m. No IHT liability arises on the death of F.[18]

This may be useful "deathbed" planning since it avoids liability to IHT even if F dies immediately after it has been carried out. It also avoids the need for a CGT disposal (and the opportunity for a CGT-free uplift on death is preserved).

Of course, the debt must not be charged on the offshore deposit. There could in principle be a back-to-back loan to minimise interest charges.

Technically the proposal cannot be faulted. Will the *Ramsay* principle apply? The risk varies depending on exactly how the arrangement is set up.

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17 See also 47.11 (Trustees borrow and acquire excluded property).

18 Except so far as property prices rise.

47.7 Debt from life tenant to estate IP trust

47.7.1 *Debt owed by non-settlor life tenant to trust*

Suppose trustees lend money to the life tenant (not the settlor) of a estate IP trust (e.g. a pre-2006 IP trust). At first sight, the position seems to be:

(1) The life tenant can claim a deduction for the burden of the debt on his death.
(2) The benefit of the debt is an asset of the trust fund, and therefore usually part of the estate of the life tenant.

These two factors, the deduction and the asset, normally cancel each other out and the position ends up at neutral. Where, however, the benefit of the debt is excluded property (i.e. foreign domiciled settlor at the time the settlement was made and the debt not UK situate) then at first sight the result is a mismatch which benefits the taxpayer:

(1) a deduction for the burden of the debt in the estate of the life tenant; and
(2) no IHT on the benefit of the debt, being excluded property.

Robert Venables QC disagrees. He cites s.49(1) IHTA and Lord Asquith's familiar dictum in *East End Dwellings v Finsbury Borough Council* [1952] AC 109[19] and continues:

> If one applies Lord Asquith's dictum, what is deemed to happen when the settlor[20] in fact borrows money from the trustees? As he is deemed to own the money before it is borrowed, he cannot borrow it from himself. The transfer of the money to himself is a non-event for inheritance tax purposes. His estate is subject to no debt, as a man cannot owe a debt to himself. The question of any such debt being treated as non-deductible in computing the value of his estate for inheritance tax purposes therefore does not arise. Conversely, however, the settled property does not include the right to sue the settlor for the

19 These are set out in 44.12 and 45.11.1 respectively.
20 Venables is considering the position of a settlor life tenant but the same applies to a non-settlor life tenant.

> money borrowed, as a man cannot have a right against himself.[21]

I respectfully agree. The effect of s.49(1) is therefore to disallow the debt.

A practical solution may be to arrange that the debt is not due to the trustees, but to a company owned by the trustees. Alternatively, perhaps, arrange that the debtor beneficiary ceases to be life tenant.

47.7.2 *Debt owed by life tenant settlor to interest in possession trust*

Suppose a debt is owed by a life tenant settlor to the trustees. At first glance the result appears to be a mismatch which could favour HMRC:

(1) the debt may be disallowed under s.103,[22] and
(2) the trustees nevertheless hold an asset which (unless excluded property) would be part of the settlor's estate.

But on the view set out in para 47.7.1 above, the debt and the asset of the trust cancel each other out and both are ignored. This is a sensible result, which fits the purpose of the legislation. In practice HMRC appear to accept this.

47.8 Debt subject to GWR

Suppose:

(1) S (not UK domiciled) creates a discretionary settlement under which S is a beneficiary.
(2) The trustees lend to S.

On the death of S, the debt is within the scope of the GWR rules and I refer to it as "the GWR debt". Since s.103 does not usually apply,[23] at first sight the debt appears to be deductible. It is not disallowed under s.49 IHTA discussed above. However, it is disallowed under s.102(3) FA

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21 "An IHT Trap for Settlors of Non-UK Resident Trusts", Robert Venables QC, OTPR, vol 4, issue 3, p.165.

22 But this would not often apply to excluded property trusts or to trusts where the settlor has an initial estate IP: see 47.3.7 (The s.103(4) defence).

23 See 47.3.7 (The s.103(4) defence).

1986. Under this section the GWR debt is treated as property to which the settlor was beneficially entitled on his death. The analysis is the same as where the settlor is a life tenant, see above. This is so whether the GWR debt is UK situate or foreign situate.[24]

47.9 Debts to and from trusts

Do not confuse two situations:

(1) The situation where an individual owes a debt to trustees (e.g. the trustees have lent money to the individual). Here:
   (a) the individual may be entitled to an IHT deduction for the burden of the debt in his estate;
   (b) the trustees have an asset, the benefit of the debt (which may or may not be excluded property).
(2) The reverse situation where trustees owe a debt to a person (e.g. an individual has lent to the trustees). Here:
   (a) the individual owns an asset in his estate, the benefit of the debt, which may or may not be excluded property;
   (b) the trustees or beneficiaries may be entitled to an IHT deduction for the burden of the debt on the trust property.

The issue of deduction for debts of trustees raises entirely different questions to which we now turn.

47.10 Deduction for debts of trustees

It is clear that trust liabilities are deductible for IHT purposes, although there is no provision which states this expressly, which has caused some confusion.

Let us consider first the position where the trustees have borrowed funds and an interest in possession terminates during the lifetime of the life tenant. There is of course a transfer of value and the value transferred is:

> equal to the value of the property *in which his interest subsisted*.

24 As to whether the GWR debt is subject to IHT under the GWR rules, see 45.10 (GWR over debt owed by the deceased).

(Section 52(1) IHTA, emphasis added)

What is "the property in which his interest subsists"? In my view it is not the settled property; it is the property subject to the trustees' lien.[25] For the trustees' lien takes priority over the interest of the life tenant. The trustees' lien is a lien over both income and capital of the trust fund. The value of property is its market value. Market value of property subject to a lien will be the net value, the value after deducting the value of the lien. In this valuation exercise we are not strictly claiming a "deduction" for the lien. We are simply ascertaining what property will fetch in the market.

Similar considerations apply where an interest in possession terminates on the death of the life tenant and in computing ten-year and exit charges.[26]

This is the correct reason why trustee liabilities are allowable.[27]

Section 103(1) FA 1986 provides:

> ... if, in determining the value of a person's estate immediately before his death, account would be taken, apart from this subsection, of a liability consisting of a debt *incurred by him* or an incumbrance created by a disposition *made by him*, that liability shall be subject to abatement.

This does not apply to debts of trustees as we are not concerned with a debt or disposition made by the individual.

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25 Where a trustee has incurred a liability as trustee, he may in principle reimburse himself out of the trust fund. For this purpose the trustee has a lien over the trust fund. One exception is where the trustee has committed a breach of trust. In the discussion here, it is assumed that is not the case.

26 Section 65(5) IHTA assumes liabilities are deductible, though it is not necessary to rely on this.

27 In *Green v IRC* [2005] STC para 12 the judge took a short cut to reach the same destination:

> "... s.49 IHTA [deems] the deceased to be beneficially entitled to 'the property' in which his life interest subsists. It does not say 'net property' (i.e. the value of the property net of trust liabilities) but that is what it must mean, and the parties to this appeal both agree that in practice that is the effect the Revenue gives to the section."

The point is discussed in detail in the 3rd ed of this book para 27.9 but it is not necessary to set this out now that *Green v IRC* has confirmed the principle that trustee debts are deductible for IHT.

On HMRC practice see for instance IHT Manual 10541 (deduction for trustees' costs).

47.10.1 *Against which trust property is deduction set?*

Where a trust has a UK domiciled settlor one may not usually mind whether a deduction for a trust debt is set against UK or foreign property as it is all subject to IHT. Where it does matter (e.g. where a trust with a foreign domiciled settlor has UK and excluded property) the principles are as follows:

(1) If the liability is an incumbrance on specific trust property, the deduction is set against that property: s.162(4) IHTA.[28]
(2) If the liability is not an incumbrance on specific trust property, it is under general trust law principles an incumbrance on the trust fund as a whole and deducted from the trust assets *pro rata*. The place of payment and residence of creditor are not relevant, and s.162(5) IHTA does not apply.

47.11 Trustees[29] borrow and acquire excluded property

47.11.1 *Foreign domiciled settlor; trust owns non-excluded property*

Suppose T is the life tenant under a trust made by a foreign domiciliary. The trust owns UK situate property worth £1m. The trustees face an IHT charge on that amount on his death.

The trustees borrow £1m charged on the UK property and deposit that sum outside the UK.

In principle, the value of the UK situate property is reduced by £1m. The value of excluded property is increased. No IHT liability arises on the death of T.[30]

Alternatively, the sum borrowed may be advanced to a (foreign domiciled) beneficiary. Watch Schedule 4A TCGA.

47.11.2 *UK domiciled settlor but foreign domiciled beneficiary*

Suppose T is the life tenant under a trust made by a UK domiciliary. Trust

28 If under the terms of the trust a liability is payable out of certain property it is for this purpose a incumbrance on that property.

29 See also 47.6 (Individual borrows and acquires excluded property).

30 Except so far as property prices increase.

property is not excluded property. T is not UK domiciled.

The trustees could solve this problem by transferring the trust property to T absolutely, but this may be impractical, and if the trust is UK resident, this may have an unacceptable CGT cost.

The trustees borrow £1m and advance that sum to the beneficiary, who deposits it outside the UK. Alternatively, if T is not ordinarily resident, the trustees may borrow and invest in exempt gilts.

In principle, the value of the trust property is reduced by £1m. T's property is excluded property, and no IHT liability arises on that on the death of T.

These examples may be useful "deathbed" planning since IHT is avoided even if T dies immediately after it has been carried out. Will the *Ramsay* principle apply? It depends how the arrangement is carried out. More care is needed than for equivalent planning by an individual.

47.12 Deduction for funeral expenses

Section 172 IHTA provides:

> In determining the value of a person's estate immediately before his death, allowance shall be made for reasonable funeral expenses.

For completeness, the IHT Manual provides:

> **10376 - Overseas funerals of non-domiciled deceased**
> You should allow overseas funeral expenses as a deduction against the UK estate, even if the deceased was not domiciled in the UK for IHT purposes.
> Although s.162(5) IHTA 1984 might seem to justify the deduction of such expenses from the non-UK estate, that sub-section cannot apply as funeral expenses are not a liability for the purposes of s.5 IHTA 1984 or s.162 IHTA 1984.

47.13 Deduction for foreign taxes

The IHT Manual provides:

> **28100. Foreign taxes**
> Special rules (IHTM27000) apply to foreign taxes that are similar in nature to inheritance tax (IHT). These may in some cases be set against the IHT liability.

For other types of foreign taxes the general rule is that they can normally only be deducted from the value of property in the country that imposes the tax. This is because the taxes are unenforceable in other countries, Government of India v Taylor [1955] AC 491.
There are three exceptions to this rule

- tax debts in the Republic of Ireland (IHTM28101)
- Canadian income tax on a deemed disposal on death (IHTM28102)
- foreign tax on shares situated in the UK (IHTM27000).

This now needs to e qualified because under international treaties foreign trusts are often enforceable in other countries.
The Manual continues:

28101. Deduction for tax debts in the Republic of Ireland
If the deceased died owing tax in the Republic of Ireland, you should allow a deduction against the free estate for any tax that has actually been paid to the Irish authorities provided the deceased

- was domiciled in the United Kingdom, and
- had no assets in the Republic of Ireland.

Where, in these circumstances, the deceased also has assets in a third country, you should apportion the tax debts.
If a deduction is claimed for any 'Probate Tax' paid in the Republic of Ireland, you must refer the matter to TG (IHTM01081) for advice. This tax, which is paid by the executors or administrators of an estate, is not covered by our Double Taxation Convention with the Republic of Ireland.
28102. Canadian income tax
Under Canadian law, the estate of an individual is deemed to have been disposed of immediately before his death. Income tax is charged on any resulting gains. If, under the (Income Tax) Double Taxation Agreement the deceased was resident in Canada, the charge applies to all property wherever situate. But if the deceased was resident in the UK the charge applies only to Canadian immovable property and to certain business property.
In a press release dated 1 August 1978, the Board announced that, by concession

- Section 5(3) IHTA 1984 will be treated as applying to income tax in Canada imposed on a deemed disposal immediately before death even though the liability may not in strictness have arisen until the person had died
- where inheritance tax (IHT) is chargeable on a person's world-wide estate, and income tax in Canada is charged on deemed gains which are attributable to property forming part of that estate, the Canadian tax will rank as a deduction in arriving at the value of the estate for IHT purposes, and
- Canadian tax will normally be treated as reducing the value of property situate outside the UK whether that property is liable to IHT or not but if the Canadian tax exceeds the value of that property the excess will be set off against the value of the UK property.

Any case in which IHT is not chargeable on the deceased's world-wide estate (for example, because the deceased was not domiciled in the UK) but deduction is claimed for Canadian income tax on a deemed disposal immediately before death should be referred to TG (IHTM01081).

CHAPTER FORTY EIGHT

IHT PLANNING BEFORE AND AFTER A CHANGE OF DOMICILE

48.1 IHT planning in anticipation of acquiring UK domicile

The basic strategy for the foreign domiciliary is to transfer his assets to a trust. If he has a foreign domicile when he makes the settlement, trust property situated outside the UK will be excluded property and will retain that status indefinitely, even if the settlor himself later becomes domiciled here. This has been common practice since 1975, and HMRC accept it.

48.1.1 *The time limit*

The foreign domiciliary who creates his trust before acquiring a UK domicile will find that neither he nor his descendants need be troubled by IHT on the trust property. The opportunity, once missed, cannot be regained so it is desirable to ascertain the exact moment when a UK domicile is acquired. There are three possibilities:

(1) The individual who has decided to make his permanent home in the UK will acquire a UK domicile as soon as he arrives here. Such an individual must carry out his tax planning before setting foot in this country.
(2) The individual who arrives here to take up residence without such an intention will acquire a UK domicile when he later forms the intention to live here permanently. He must carry out his tax planning before his mind is made up. In practice, he should do so as soon as possible and preferably while his long-term intentions remain unclear.

(3) The individual who arrives and remains residing in the UK without

deciding to live here permanently will acquire a deemed UK domicile after 15 to 17 years' residence here: see 43.2 (Deemed UK domicile). This is the long-stop deadline for this basic IHT planning, although limited planning opportunities remain available for the deemed domiciliary: see 43.9 (Tax planning for the deemed domiciliary).

48.1.2 *Form of trust*

A suitable trust will take the following form:

(1) income to be accumulated or paid to someone other than the settlor or his spouse for three months;[1]
(2) subject thereto income is to be paid to the settlor for his life;
(3) subject thereto the trust fund is to be held on discretionary trusts for the benefit of the family of the settlor.

Trust income will belong to the life tenant but (if not UK domiciled) he may mandate the trustees to retain the income and add it to capital. This may be useful to avoid "relevant income": see 19.15 (Is income of life tenant relevant income?).

A simple discretionary settlement is also a possible form. For a full discussion of the drafting issues, see *Drafting Trusts and Will Trusts*, 8th ed., 2006 (James Kessler QC).

48.2 General strategy for trustees of trust with foreign domiciled settlor

There are two general points. The first is to avoid UK situate property, at least when it matters: see 44.21 (IHT planning for individuals).

Trust property in a settlement created by a true foreign domiciliary can remain effectively out of the inheritance tax net so long as the trust continues to exist. The trustees should be reluctant to appoint trust capital to a beneficiary who is or may become UK domiciled; that property may cease to be excluded property. On the contrary, all possible steps should be taken to maintain the life and value of the trust. If necessary, steps should be taken to extend its life by exercising powers of appointment or

1 Provision (1) is necessary to prevent the settlor having an initial interest in possession which could have inconvenient results if the settlor were to become domiciled in the UK: see 44.13 (Initial interest of settlor or spouse).

advancement.

If a UK domiciled beneficiary has substantial assets in his own estate then it may be worth adopting a policy of gradually realising his own assets while allowing his trust fund to accumulate or invest for capital growth. The beneficiary might gradually realise his free capital, or perhaps use it to purchase an income tax efficient annuity.

48.3 IHT planning: trusts made by UK domiciled settlor who later acquires foreign domicile

What is the best form of tax planning where a settlor has made a settlement while UK domiciled and later acquires a foreign domicile? If nothing is done the trust property cannot be excluded property.

A good solution is to transfer the trust property back to the settlor. That may be impractical if:

(1) the settlor is not a beneficiary, or
(2) commercial or foreign tax or UK CGT considerations make this course unattractive.

In such a case, a second-best but workable solution may be:

(1) the settlor creates a new trust; and
(2) the trustees of the old trust transfer the trust property to the new trust.

See 46.8 (Transfer from trust made by A to another trust made by A).

A third-best solution involves loans: see 47.11 (Trustees borrow and acquire excluded property).

CHAPTER FORTY NINE

IHT ON DEATH: WILLS AND IOVs

49.1 Will drafting – General approach

There has always been considerable scope for tax saving through an appropriately drafted will. On disclosure rules on death, see 61.10 (Reporting requirements on death of foreign domiciled individual).

49.1.1 *Foreign domiciled testator: UK domiciled beneficiaries*

From an IHT viewpoint, the will should in principle provide that the estate is held on trust for the beneficiaries so that trust property situated outside the UK will remain excluded property.

49.1.2 *UK domiciled testator: foreign domiciled beneficiaries*

Here, conversely, the testator should in principle give his estate to beneficiaries absolutely so that the property may qualify as excluded property in their hands. But a short-term discretionary will trust within s.144 IHTA is just as good, and allows additional flexibility.

49.2 IHT spouse exemption on death of a foreign domiciliary

Section 18 IHTA provides:

> (1) A transfer of value is an exempt transfer to the extent that the value transferred is
> [a] attributable to property which becomes comprised in the estate of the transferor's spouse or civil partner or,
> [b] so far as the value transferred is not so attributable, to the extent that

that estate is increased.[1]

I refer to this as “**the IHT spouse exemption**”.[2]

Suppose:

(1) H (not UK domiciled) dies leaving an estate which consists of:
    (a) UK property (not excluded property), and
    (b) foreign situate property (which is excluded property).
(2) Part of H’s estate passes[3] to his widow W.

This raises the interesting question of the interaction of the excluded property rules and the IHT spouse exemption. Sections 4 and 5 IHTA provide:

> **4 Transfers on death**
> (1) On the death of any person tax shall be charged as if, immediately before his death, he had made a transfer of value and the value transferred by it had been equal to the value of his estate immediately before his death. ...
> **5 Meaning of estate**
> (1) For the purposes of this Act a person’s estate is the aggregate of all the property to which he is beneficially entitled, except that ...
> (b) the estate of a person immediately before his death does not include excluded property.

The following propositions are clear:

(1) IHT is charged as if H made a transfer of value (“the deemed transfer of value”).

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1 I add for completeness that ss.18(3) and 56 contain anti-avoidance provisions rarely in point and not discussed here. There is a full discussion on the (almost) identical charity provisions in *Taxation of Charities*, Kessler & Kamal, Key Haven Publications (6th ed., 2007). For the restriction for foreign domiciled spouses, see 53.2 (Restriction on IHT spouse exemption for foreign domiciled spouse).

2 References to spouse, marriage, and widow/ers here include a civil partner, civil partnership and a surviving civil partner. See Appendix 1.2 (Meaning of spouse) and 1.3 (Civil partners).

3 By will, by survivorship or by the relevant succession law; this makes no difference.

(2) The estate of H immediately before his death did not include his excluded property.
(3) The value transferred by the deemed transfer of value is equal to the value of H's estate (which is the value of the UK situate property).

Suppose, first, that on the death of H only his foreign situate (excluded) property passes to his spouse. Does the spouse exemption apply? Section 18(1) IHTA provides:

> A transfer of value is an exempt transfer to the extent that the value transferred is
> [a] attributable to property which becomes comprised in the estate of the transferor's spouse or,
> [b] so far as the value transferred is not so attributable, to the extent that that estate is increased.[4]

The deemed transfer of value is not exempt under s.18(1)[a]. There is "property which becomes comprised in the estate of the spouse". However, the value transferred is not attributable to that property. That leaves the exemption in s.18(1)[b]. A transfer of value is an exempt transfer to the extent that the estate of the spouse is increased. The estate of the spouse is increased on the death of H.[5] It is therefore considered that the spouse exemption does apply on a plain reading of the words.[6] Is this result so absurd that the courts should not adopt a plain reading? I do not see why it should be regarded as absurd. If W is UK domiciled the application of the spouse exemption on the death of H is reasonable, because W's estate is increased and the property W receives will be subject to tax on the death of W. It might be said to be anomalous because a simple lifetime gift of excluded property by H to his spouse would not be a transfer of value, so it would not qualify as an exempt transfer under the IHT spouse exemption. But of course in such a case the spouse

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4 In the case considered here the restriction in s.18(2) does not apply since H (the transferor) is not domiciled in the UK.

5 This is the case even if the property is excluded property in the estate of W (which will be the case if W was not UK domiciled). Excluded property is "property" for IHT and (except immediately before death) a person's estate includes his excluded property.

6 Exemption is given to the extent of the value of the property given to W.

exemption is not needed.[7] If the contrary view were adopted, then the practical consequence should not be to raise more funds for HMRC, but only to pose a trap for taxpayers and their advisors.

Now suppose H leaves W a pecuniary legacy. The IHT Manual provides at IHTM11013 [October 2007]:

> Where the will of a person domiciled (IHTM13000) abroad disposes of his UK estate and some or all of his world estate, exemption for pecuniary legacies (IHTM12082) should be given against the UK estate in the proportion which that bears to the world estate, and not wholly against the UK estate. Where you have difficulty in obtaining details of the world estate, or where the official practice meets resistance, you should refer the case to TG.

This is correct in relation to charities. The IHT charity exemption is more narrowly worded. But for spouses, it is not consistent with the words of s.18(1)[b]. It is suggested that the spouse exemption applies to the full extent of the pecuniary legacy. It makes no difference whether the pecuniary legacy is subsequently paid out of UK or foreign situate property.

Chapter 3 Part 2 IHTA (Allocation of Exemptions) does not shed much light on the issue. Section 36 IHTA provides that these rules apply where (*inter alia*) s.18 IHTA applies:

> in relation to a transfer of value but the transfer is not wholly exempt …

In the circumstances we are envisaging, the transfer will be "wholly exempt" if the value given to the spouse equals the value of the UK situate property. What happens if the value given to the spouse is less than the value of the UK situate property so the transfer is not wholly exempt? Let us assume that what the spouse receives is a "specific gift" as defined in s.42(1). Section 38(1) IHTA provides that:

> Such part of the value transferred shall be attributable to specific gifts as corresponds to the value of the gifts …

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7 The end result is consistent with the exemption for funeral expenses, which are set against UK property alone; see 47.12 (Deduction for funeral expenses).

This confirms the view taken above.

49.3 Drafting will of foreign domiciliary

49.3.1 *Gift to spouse by will*

Where a foreign domiciled testator has non-excluded property and excluded property, and is married so the IHT spouse exemption is fully available, the safe course will be:

(1) to give the non-excluded property to:
  (a) the spouse; or
  (b) a trust where the spouse has an interest in possession (better where the spouse is UK domiciled).
(2) to give excluded property to other persons.

A pecuniary legacy to the spouse should be charged on non-excluded property. Watch the drafting.

This course should avoid a dispute with HMRC. However, it is not necessary.

Where a UK domiciled testator has a foreign domiciled spouse, the usual IHT spouse/civil partner exemption does not apply (ignoring the small £55k allowance). The choice for the will lies between a discretionary will trust or an absolute gift to the foreign domiciled spouse. Which is better? Either way, there is a charge to IHT on the death of the testator. But if the property is given to the spouse, it is outside the scope of IHT thereafter, so long as it is not UK situate. If the property is given to a will trust, it remains within the scope of IHT, it is not excluded property, as the will trust has a UK domiciled settlor. So at first sight, the absolute gift seems better. Having said that, if property goes into the discretionary will trust and out to the spouse again within two years, the IHT position is just the same as a direct gift: s.144 IHTA 1984. And it may be desired to pass the property to others, perhaps giving it to the next generation (particularly if not UK domiciled). Also when the testator makes the will, one would not usually know the domicile position at the time of the death. If the spouse/civil partner lives long enough, she may become deemed UK domiciled for IHT purposes. All things considered, the discretionary will trust seems the more flexible and safer course for the will, in a routine case. In most cases, the will trust is likely to be wound up within two years. But the only cost is the cost of the deed of appointment.

49.3.2 *Charitable gifts by will*

Where a foreign domiciled testator has non-excluded property and excluded property, the correct strategy will be:

(1) to give the non-excluded property to UK charities;
(2) to give excluded property to other persons.

A pecuniary legacy to the charity should be charged on non-excluded property.

49.4 Instruments of variation ("IOVs")

The IHT Manual provides:

> **35094 - Redirection of excluded property** [June 2006]
> Another scheme (see also IHTM35093) where the taxpayers seek to take advantage of the provisions of s.142 IHTA 1984 without there being a bona fide variation is where the estate contains excluded property (IHTM04251) such as government securities.
> The deceased, domiciled (IHTM13000) outside the UK, may leave property in this country to chargeable beneficiaries and excluded property to the spouse or civil partner (IHTM11032). An IoV may then be used for the spouse's or civil partner's entitlement to be switched from excluded property to the ordinary UK estate without any change in the amount the spouse or civil partner receives.
> You should refer cases of this type immediately above to TG (IHTM01081) without making any preliminary enquiries provided the basic facts are clear.

I do not understand in what sense it could be said that this is not a "bona fide variation".[8] Section 142(5) IHTA expressly envisages an IOV relating to excluded property.

A variation of this kind cannot sensibly be challenged if properly carried out. If the author's view of the spouse exemption is right, however, an

8 It would be different if there was an arrangement under which the spouse later swapped the UK property for the excluded property.

IOV would not be necessary. (It may nevertheless be desirable as a useful precaution where a will has not been drafted in the manner recommended above.)

CHAPTER FIFTY

IHT PRE-1975 DOUBLE TAX TREATIES

50.1 Pre-1975 double tax treaties – Introduction

In this chapter I consider the pre-1975 IHT double tax treaties. There are four treaties which I call the India, Pakistan, Italy and France IHT DTTs.[1] They are similar but not identical. The treaties are important to those who are deemed domiciled in the UK, but treaty-domiciled in India, Pakistan, Italy or France. The next chapter considers the USA IHT treaty. I hope to deal with other treaties in a later edition. The following chapter deals with unilateral IHT relief.

Section 158(1) IHTA provides authority for IHT double taxation treaties:

> If Her Majesty by Order in Council declares—
> (a) that arrangements specified in the Order have been made with the government of any territory outside the UK with a view to affording relief from double taxation in relation to capital transfer tax payable

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1 For some reason DTTs do not have short titles. The full titles are:

(1) Agreement between the Government of the United Kingdom and the Government of India for the avoidance of double taxation and the prevention of fiscal evasion with respect to duties on the estates of deceased persons [SI 1956 No. 998]

(2) Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Pakistan for the avoidance of double taxation and the prevention of fiscal evasion with respect to duties on the estates of deceased persons [SI 1957 No. 1522]

(3) Convention between the United Kingdom of Great Britain and Northern Ireland and France for the Avoidance of Double Taxation with respect to Duties on the Estates of Deceased Persons [SI 1963 No. 1319]

(4) Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Italian Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Duties on the Estates of deceased persons [SI 1968 No. 304].

under the laws of the UK and any tax imposed under the laws of that territory which is of a similar character or is chargeable on or by reference to death or gifts inter vivos, and

(b) that it is expedient that those arrangements should have effect,

the arrangements shall, notwithstanding anything in this Act, have effect so far as they provide for relief from capital transfer tax, or for determining the place where any property is to be treated as situated for the purposes of the tax.

50.2 Application of estate duty treaties to IHT

India DTT Art. I provides:

> The duties which are the subject of the present Agreement are
> (a) In India, the estate duty imposed under the Estate Duty Act, 1953 (No. 34 of 1953), and
> (b) In the UK, the estate duty imposed in Great Britain.

Article II (1) provides commonsense definitions of India, Great Britain, UK, territory, and duty, which need not be repeated here.

Although the treaty refers to Great Britain, it also applies in Northern Ireland.[2]

The treaty refers to UK estate duty, a predecessor of IHT, but it is extended to IHT by s.158(6) IHTA:

> Where arrangements with the government of any territory outside the UK are specified under any Order in Council which—
> (a) was made, or has effect as made, under section 54 of the Finance (No 2) Act 1945 or section 2 of the Finance Act (Northern Ireland) 1946, and
> (b) had effect immediately before the passing of this Act,
> the Order shall, notwithstanding the repeal of that section by the Finance Act 1975 remain in force and have effect as if any provision made by those arrangements in relation to estate duty extended to capital transfer

2 India DTT Art. X provides: "The present Agreement shall apply in relation to the estate duty imposed in Northern Ireland as it applies in relation to the estate duty in Great Britain, but shall be separately terminable in respect of Northern Ireland by the same procedure as is laid down in Article XII." This was because Northern Ireland was from 1921 a separate unit for estate duty purposes.

tax[3] chargeable by virtue of section 4 above; ...[4]

The Pakistan, Italy and France DTTs are substantially the same: see Arts. I and II of each DTT.

50.3 Treaty IHT exemption

India DTT Art. III(3) provides:

> (3) [a] Duty shall not be imposed in Great Britain on the death of a person who was not domiciled at the time of his death in any part of Great Britain but was domiciled in some part of India on any property situated outside Great Britain :
>
> [b] Provided that nothing in this paragraph shall prevent the imposition of duty in Great Britain on any property which passes under a disposition or devolution regulated by the law of some part of Great Britain.

Italy is more or less the same but in different words:

> Where duty is imposed in the territory of one Contracting Party on the death of a person who at the time of his death was not domiciled in any part of that territory but was domiciled in some part of the territory of the other Contracting Party, no account shall be taken, in determining the amount or rate of such duty, of property situated outside the former territory, provided that this paragraph shall not apply to duty imposed in the territory of a Contracting Party on property passing under a settlement governed by its law.

France is slightly different again. France DTT Art. V(1) provides:

> Where a person was at the time of his death domiciled in some part of

3 The reference to CTT has effect as a reference to IHT: s.100 FA 1986.

4 The Italy treaty adds:

> "The present Convention shall also apply to any other duties of a substantially similar character to the duties referred to in para (1) above which may be imposed in Great Britain or Italy subsequently to the date of signature of the present Convention."

This is also in the France and Pakistan DTTs. It is missing from the India treaty but it makes no difference as s.158 does the same work.

> France duty shall not be imposed in Great Britain on any property which neither is situated in Great Britain, nor passes under a disposition or devolution regulated by the law of some part of Great Britain; and, in determining the amount or rate of duty payable in Great Britain, such property shall be disregarded.

Pakistan is slightly different again. Pakistan DTT Art. V(2) provides:

> Where a person at the time of his death was domiciled in some part of Pakistan and was not domiciled in some part of Great Britain, duty shall not be imposed in Great Britain on any property which for the purposes of duty passes or is deemed to pass on his death unless that property—
> (a) is situated in Great Britain, or
> (b) passes under a disposition or devolution regulated by the law of some part of Great Britain;
> and, in determining the amount or rate of duty payable in Great Britain, property not falling within sub-para (a) or (b) shall be disregarded.

I refer to this as "**treaty IHT exemption**".

The exemption applies only to duty imposed on a death. That includes the charge which applies on property in the individual's free estate, property in an estate IP trust, and property within the GWR charge on death.

What about the charge on a lifetime PET which becomes a chargeable transfer because the transferor dies within 7 years? On a strict reading there is no relief, since the charge is on the lifetime transfer of value. The charge is not on the death, even though it is only on the death that the transfer becomes chargeable. Could a purposive construction help? The relief would have applied to the estate duty charge on lifetime gifts within 7 years of death. In substance the charge on failed PETs is a charge on death. If one were construing the treaty alone, this would be a strong argument, for treaties are not interpreted strictly or literally. But s.158(6) IHTA provides that the treaties have effect for IHT only in relation to IHT "chargeable by virtue of s.4 IHTA". The IHT charge on a failed PET is not under s.4, so the treaty does not apply. This is odd, perhaps absurd. But the treaties give rise to many other anomalies. There is no relief on ten-year charges on trusts. There is clearly no relief on a lifetime chargeable transfer which is not a PET, such as a gift to a trust.[5]

50.3.1 *Planning*

This raises tricky planning choices. One strategy is for an elderly individual *not* to make any gifts, to retain property until death. The lifetime gift may be taxable and the death estate tax free. But the risk of that approach is that by the time of the death the treaty may have been repealed. The lifetime gift may be better—if the donor survives seven, or at least three years.

Sometimes one spouse is and the other is not within the scope of the treaty. In that case inter-spouse gifts (or will trusts conferring an IP on the appropriate spouse) will bring the property within the scope of the treaty.

50.4 Domicile requirements of treaty IHT exemption

50.4.1 *Individual not UK domiciled*

The requirement for IHT exemption in the India and Pakistan DTTs is that the individual must not be domiciled in the UK. For this purpose the deemed domicile rule does not apply. Section 267(2) IHTA provides:

> Subsection (1) above [deemed domicile rule] ... shall not affect the interpretation of any such provision as is mentioned in section 158(6) above [pre-CTT treaties].

The reason is that estate duty had no equivalent of the deemed domicile rule. When CTT was introduced, therefore, it would have been necessary either to renegotiate existing treaties (introducing new rules at least for treaties which lacked a tie-breaker) or to keep the treaties free from the deemed domicile rule. Presumably the former course was thought to be more trouble than it was worth.

IHT exemption in the Italy DTT also has the requirement that the individual is not domiciled in the UK. However, this treaty has a tie-breaker for an individual who is both domiciled in the UK and treaty-domiciled in Italy. If Italy wins under the tie-breaker, it is clear that the individual is regarded as not UK domiciled. So the requirement to be non-

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5 It appears from an incoherent passage in the IHTM para 13024 that HMRC agree.

UK domiciled adds nothing.

IHT exemption in the France DTT (which also has a domicile tie-breaker) does not include the requirement that the individual is not domiciled in the UK. Since the Italy DTT (1968) came well after the France DTT (1963) it is strange that the Italy wording did not copy the France one. But there it is.

50.4.2 *Domicile in treaty state*

The requirement for IHT exemption in each treaty is that the individual must be domiciled in the treaty state. But "domicile" here has a non-standard meaning so I refer to it as "**treaty-domicile**".

50.4.3 *Treaty-domicile: India and Pakistan*

India DTT Art. II(2) provides:

> For the purposes of the present Agreement, the question whether a deceased person was at the time of his death domiciled in any part of the territory of one of the Contracting Governments shall be determined in accordance with the law in force in that territory.

Pakistan is differently worded but the same in substance. Pakistan DTT Art. II(2) provides:

> For the purposes of the present Agreement, the question whether a deceased person was at the time of his death domiciled in any part of Great Britain or in any part of Pakistan shall be determined in accordance with the law in force in Great Britain and Pakistan respectively.

Thus the individual must be domiciled in India/Pakistan under Indian/Pakistan law. One should not assume that Indian/Pakistan law of domicile is the same as in the UK.[6]

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6 Note the view of *Dymond's Death Duties* (15th edition 1973):

> "The Indian (and Pakistan) law (contained in the Indian Succession Act 1925) is basically similar to British law but somewhat less stringent in its requirements, ie. the conception of 'domicile' is a little nearer to that of 'residence'."

50.4.4 *Treaty-domicile: Italy and France*

Italy DTT art.II(2) repeats the India DTT but goes on to add a tie-breaker clause:

> (2)(a) For the purposes of the present Convention, the question whether a deceased person was domiciled at the time of his death in any part of the territory of one of the Contracting Parties shall be determined in accordance with the law in force in that territory.
>
> (b) Where by reason of the provisions of the preceding paragraph a deceased person is deemed to be domiciled in the territory of each of the Contracting Parties, then this case shall be solved in accordance with the following rules:
>
> (i) he shall be deemed to be domiciled in the territory of the Contracting Party in which he had a permanent home available to him at the time of his death; if he had a permanent home available to him in the territory of each of the Contracting Parties he shall be deemed to be domiciled in the territory of the Contracting Party with which his personal and economic relations were closest (centre of vital interests);

It is not often necessary to look beyond this point but, for completeness, the DTT continues.

> (ii) if the Contracting Party in whose territory he had his centre of vital interests cannot be determined, or if he had not a permanent home available to him in the territory of either Contracting Party, he shall be deemed to be domiciled in the territory of the Contracting Party in which he had an habitual abode;
>
> (iii) if he had an habitual abode in the territory of each of the Contracting Parties, or in the territory of neither, he shall be deemed to be domiciled in that of which he was a national;
>
> (iv) if he was a national of both territories or of neither of them, the taxation authorities of the Contracting Parties shall determine the question by mutual agreement.

The tie-breaker wording follows the tie-breaker in the OECD Model

I would be grateful if any reader could direct me to authority on whether this is a correct statement of the law of India and Pakistan.

Convention definition of residence, art.4(2) and reference should be made to the OECD Commentary.[7] France is the same as Italy: France DTT Art. II(3). A key question is what is required for a person to be domiciled in Italy under Italian law.

50.5 Treaty situs rules

The next requirement of treaty IHT exemption is that the property must not be situate in the UK. For this purpose the DTTs contain situs rules ("treaty situs rules"). The rules are those recommended in a report on Double Taxation prepared for the League of Nations in 1923 by Professors Bruins and Seligman and our own Sir Josiah Stamp, and the report is worth reading as it give the background. Many of the rules repeat the usual IHT situs rules but some are different.

50.5.1 *Treaty situs rules: India, Pakistan, Italy*

India DTT Art. IV(1) provides:

> Subject to para (2) of this Article, where a person was at the time of his death domiciled in any part of the territory of one of the Contracting Governments, ...

This is the case we are considering.

> ... the situs of any property *which for the purposes of duty passes or is deemed to pass on his death* shall, for the purposes of the imposition of duty and of the credit to be allowed under Art. VI, be determined exclusively in accordance with the rules in Art. V of the present Agreement.

However there is a condition in art.IV(2):

> Para (1) of this Article shall apply if, and only if, apart from the said Art. V—
> (a) duty would be imposed on the property under the law of each of the Contracting Governments; or

7 This is discussed in the third edition of this work, para 17.16.

(b) duty would be imposed on the property under the law of one of the Contracting Governments and would, but for some specific exemption, also be imposed thereon under the law of the other Contracting Government.

This condition will never be satisfied under the Indian treaty, since estate duty in India was repealed in 1985. (Significantly, about the same time, the Thatcher Government was drawing the teeth of CTT, though the UK did not follow India all the way to abolition.) So the treaty situs rules in the India DTT will never apply.

Pakistan is the same: Pakistan DTT art.III. Pakistan's estate duty was abolished in 1979. One wonders why the treaties have survived more than two decades after losing their *raison d'être.*

Italy is substantially the same: Italy DTT Art. III(1)(2). It omits the phrase italicised above, but those words add nothing. The Italy treaty situs rules ceased to apply in 2001 because Italy abolished its succession duty and estate duty (*imposta sull'asse ereditario globale*) – a Berlusconi reform. However, in November 2006 the Prodi Government reintroduced a succession tax.

50.5.2 *Treaty situs rules: France and Italy*

France retains its duty on successions on death, so the treaty situs rules are relevant. I here set out the rules in the French Treaty art.4 highlighting in italic those significantly different from IHT situs rules:

(a) land shall be deemed to be situated at the place where it is located; rights or interests (otherwise than by way of security) which constitute immovable property shall be deemed to be situated at the place where the land to which they relate is located; the question whether rights or interests constitute immovable property shall be determined in accordance with the law of the place where the land to which they relate is located;
(b) tangible movable property (other than such property for which specific provision is hereinafter made) and rights or interests (otherwise than by way of security) therein shall be deemed to be situated at the place where it is located at the time of the deceased person's death or, *if in transitu, at the place of destination*; and bank or currency notes or other forms of currency recognised as legal tender in the place of issue shall be treated as tangible movable property for the purpose of this subparagraph;
(c) debts, secured or unsecured, excluding those for which specific provision is made in this Article, *but including debentures and debenture stock issued by a company, bills of exchange, promissory notes and cheques shall be deemed*

to be situated at the place where the deceased person was domiciled at the time of his death;
(d) *securities issued by any government, county council, département, municipality or other public authority shall be deemed to be situated at the place where the deceased person was domiciled at the time of his death*;
(e) *shares or stock in a company (including any such property held by a nominee, whether the beneficial ownership is evidenced by scrip certificates or otherwise) shall be deemed to be situated at the place where the company was incorporated*;
(f) *moneys payable under a policy of assurance or insurance shall be deemed to be situated at the place where the deceased person was domiciled at the time of his death*;
(g) an interest in a partnership, which term includes a société en nom collectif, a société en commandite simple and a société civile under French law, shall be deemed to be situated at the place where the business is principally carried on; and in the case of a société civile immobilière this shall be where the land developed in accordance with the objects of the société is located;
(h) goodwill as a trade, business or professional asset shall be deemed to be situated at the place where the trade, business or profession to which it pertains is carried on;
(i) ships and aircraft and shares thereof shall be deemed to be situated at the place of registration of the ship or aircraft;
(j) patents, trade marks, designs, copyright, and rights or licences to use any patent, trade mark, design or copyrighted material shall be deemed to be situated at the place where the deceased person was domiciled at the time of his death;
(k) *rights or causes of action ex-delicto*[8] *surviving for the benefit of the estate of a deceased person shall be deemed to be situated at the place where the deceased person was domiciled at the time of his death*;
(l) *judgment debts shall be deemed to be situated at the place where the deceased person was domiciled at the time of his death*;
(m) *any other right or interest shall be deemed to be situated at the place determined by the law in force in the territory of the Contracting Party where the deceased person was not domiciled at the date of his death.*

50.6 Proper law

Lastly, treaty IHT exemption in India, Pakistan and France does not apply to property which passes under a disposition or devolution regulated by the law of some part of Great Britain.

Italy is not quite the same. The restriction is that the exemption does not apply to property passing under a *settlement* with a UK law (so the exemption could apply in Italy to property passing under a UK law will,

8 i.e. torts, not contractual rights.

but not elsewhere).

This follows estate duty principles, where the territorial limits of the tax depended partly on domicile and situs (as IHT) but also on whether the proper law of the disposition or devolution under which the property passes was a law of the UK. The requirement makes little sense for the IHT regime, but logic is not to be expected when estate duty treaties are left unamended to apply to IHT.

This is a complex topic, with many cases to consider. For a discussion, see the scholarly *Dymond's Death Duties*, 15th edition, 1973 pp 1286–1312.

50.7 Transferable nil rate bands and IHT double taxation reliefs

Section 8A IHTA provides

> **8A Transfer of unused nil-rate band between spouses and civil partners**
> (1) This section applies where—
> (a) immediately before the death of a person (a "deceased person"), the deceased person had a spouse or civil partner ("the survivor"), and
> (b) the deceased person had unused nil-rate band on death.

Section 8A(2) IHTA defines "unused nil rate band on death":

> (2) A person has unused nil-rate band on death if—
> M > VT
> where—
> M is the maximum amount that could be transferred by a chargeable transfer made (under section 4 above) on the person's death if it were to be wholly chargeable to tax at the rate of nil per cent. (assuming, if necessary, that the value of the person's estate were sufficient but otherwise having regard to the circumstances of the person); and
> VT is the value actually transferred by the chargeable transfer so made (or nil if no chargeable transfer is so made).

The availability of a transferable nil rate band depends on whether there was a chargeable transfer on the death of the first spouse. Assuming there would be a chargeable transfer (but for IHT DTT relief) does the availability of DTT relief alter the position? The IHTM para 43025 provides:

> **Transferable Nil Rate Band: interaction of ability to transfer unused nil rate band with double taxation agreements, double taxation relief and successive charges relief**
> The extent to which an estate is chargeable to tax may be governed by a double taxation agreement [IHTM27161], or a liability to tax may be reduced to nil by double taxation relief [IHTM27181] or successive charges relief [IHTM22041].
> [1] Where, under the terms of a double taxation agreement, an asset is not subject to tax, then if this means that the chargeable estate is below the nil rate band, the amount unused is available for transfer.
> [2] However, where there is a liability to tax that is reduced to nil by either double taxation relief or successive charges relief, the nil rate band remains fully used. We do not repay any "excess" relief and there is no provision to convert "excess" relief into unused nil rate band.

Unilateral relief takes the form of a credit against IHT. It falls within [2]. Where that relief applies there is still a chargeable transfer so that transferrable NRB relief does not become available.

The India France and Pakistan DTTs provide that "duty shall not be imposed" on certain property. The USA DTT provides that certain property "shall not be taxable" in the UK. These reliefs fall within [1]. It is not obvious that this prevents there being a chargeable transfer but it might be said to follow from a commonsense reading. Treaties are not to be construed technically. HMRC read the legislation in this way, so that the transferable nil rate band is available to the surviving spouse.

The Italian DTT provides that "No account shall be taken, in determining the amount or rate of duty" on death, in relation to certain property. It is considered that the effect is the same as the other pre-1975 DTTs.

50.8 Claims for DTT relief

There is no formal claim for IHT relief (unlike the position for IT where s.788(6) ICTA requires a claim.) However if an IHT account is in principle required on a death, under s.216 IHTA, a treaty saying that tax "shall not be imposed" or property "shall not be taxable" (as most of the pre-1975 treaties or the US IHT DTTs) do not override this requirement. The same applies to the differently worded exemption in the Italy DTT ("no account shall be taken in determining the amount or rate of duty...")

Similarly, for a deemed domiciled individual, the US treaty does not override the duty to disclose a lifetime chargeable transfer or the making of a non-resident settlement under s.218 IHTA 1984.

So the usual returns would be made with a claim (not strictly a formal claim, but a statement or allegation) that there is no IHT as DTT relief applies.

CHAPTER FIFTY ONE

USA IHT TREATY

51.1 USA IHT treaty – Introduction

This chapter considers the USA IHT Treaty.[1]

For some reason DTTs do not have short titles. I use the expression "**USA IHT DTT**" (or, for short, just DTT) to refer to the DTT dated 19 October 1978 officially called "the Convention between the Government of the USA and the Government of the UK for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on estates of deceased persons and on gifts".

I comment only on the UK aspects of the treaty. Separate US advice will be needed in any case where the treaty applies.

For the interaction of the USA IHT DTT and transferable nil rate bands, see 50.7 (Transferable nil rate bands and IHT double taxation reliefs).

51.2 Scope

Article 1 USA IHT DTT provides:

> This Convention shall apply to any person who is within the scope of a tax which is the subject of this Convention.

Thus the DTT applies to trustees as well as to individuals, even if the trustees are not themselves US treaty-domiciled.

51.3 Taxes covered

Article 2 USA IHT DTT provides:

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1 The text is accessible on *http://uniset.ca/misc/us-uk_esttax.html*

> (1) The existing taxes to which this Convention shall apply are:
> (a) in the US: the Federal gift tax and the Federal estate tax, including the tax on generation-skipping transfers; and
> (b) in the UK: the capital transfer tax.
> (2) This Convention shall also apply to any identical or substantially similar taxes which are imposed by a Contracting State after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any changes which have been made in their respective taxation laws.

The DTT applies to IHT which is "substantially similar" to CTT.

51.3.1 *"Tax"*

Article 3(f) USA IHT DTT provides:

> the term "tax" means:
> (i) the Federal gift tax or the Federal estate tax, including the tax on generation-skipping transfers, imposed in the US, or
> (ii) the capital transfer tax imposed in the UK, or
> (iii) any other tax imposed by a Contracting State to which this Convention applies by virtue of the provisions of para (2) of Article 2, as the context requires.

51.4 Definitions

The DTT provides commonsense definitions of the following terms, which are not set out here:

US
UK
Enterprise
Competent Authority
Contracting State

51.4.1 *"National*"

Article 3(e) USA IHT DTT provides:

> the term "nationals" means:
> (i) in relation to the US, US citizens, and
> (ii) in relation to the UK any citizen of the UK and Colonies, or any British subject not possessing that citizenship or the citizenship of any other Commonwealth country or territory, provided in either case he had the right of abode in the UK at the time of the death or a transfer.

51.4.2 *"Decedent"*

The DTT uses the term "decedent" which is an Americanism for "deceased".

51.4.3 *Undefined terms*

Article 3(2) USA IHT DTT provides:

> As regards the application of the Convention by a Contracting State, any term not otherwise defined shall, unless the context otherwise requires and subject to the provisions of Article 11 (Mutual Agreement Procedure), have the meaning which it has under the laws of that Contracting State relating to the taxes which are the subject of the Convention.

51.5 Treaty-domicile

For present purposes there are three types of domicile:

(1) domicile in the ordinary English law sense ("actual domicile");
(2) deemed UK domicile for IHT ("deemed UK domicile");
(3) domicile for the purposes of the treaty ("treaty-domicile").

The definition of treaty-domicile is distinctly non-standard. Article 4(1) USA IHT DTT provides:

> For the purposes of this Convention an individual was domiciled:
> (a) in the US:
> [i] if he was a resident (domiciliary) thereof or
> [ii] if he was a national thereof and had been a resident (domiciliary) thereof at any time during the preceding three

years

The definition of resident (domiciliary) is crucial: this is a matter of US law and I would be grateful to any reader who could direct me to relevant authority.

Article 4(1) USA IHT DTT provides:

> For the purposes of this Convention an individual was domiciled: ...
> (b) in the UK:
> [i] if he was domiciled in the UK in accordance with the law of the UK [ie if actually UK domiciled]
> [ii] or is treated as so domiciled for the purpose of a tax which is the subject of this Convention [i.e. if deemed UK domiciled].

Next come a series of tie-breakers to deal with persons who under (1)(a) and (b) would be treaty-domiciled in both jurisdictions:

> (2) Where by reason of the provisions of para (1) an individual was at any time domiciled in both Contracting States, and
> (a) was a national of the UK but not of the US, and
> (b) had not been resident in the US for Federal income tax purposes in seven or more of the ten taxable years ending with the year in which that time falls,
>
> he shall be deemed to be domiciled in the UK at that time.
> (3) Where by reason of the provisions of para (1) an individual was at any time domiciled in both Contracting States, and
> (a) was a national of the US but not of the UK, and
> (b) had not been resident in the UK in seven or more of the ten income tax years of assessment ending with the year in which that time falls,
>
> he shall be deemed to be domiciled in the US at that time.
> For the purposes of this paragraph, the question of whether a person was so resident shall be determined as for income tax purposes but without regard to any dwelling-house available to him in the UK for his use.

The last sentence is based on wording formerly in the IHT deemed domicile rule, and is discussed in 43.5 (Meaning of "residence" for 17-year residence rule).

Where these tie-breakers fail to break the tie, we turn to Art. 4(4):

> Where by reason of the provisions of para (1) an individual was

> domiciled in both Contracting States, then, subject to the provisions of paras (2) and (3), his status shall be determined as follows:
> (a) the individual shall be deemed to be domiciled in the Contracting State in which he had a permanent home available to him. If he had a permanent home available to him in both Contracting States, or in neither Contracting State, he shall be deemed to be domiciled in the Contracting State with which his personal and economic relations were closest (centre of vital interests);
> (b) if the Contracting State in which the individual's centre of vital interests was located cannot be determined, he shall be deemed to be domiciled in the Contracting State in which he had an habitual abode;
> (c) if the individual had an habitual abode in both Contracting States or in neither of them, he shall be deemed to be domiciled in the Contracting State of which he was a national; and
> (d) if the individual was a national of both Contracting States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

This is the standard OECD Model wording, and the OECD Commentary will be relevant.

51.5.1 *Resident of possession of the US*

Article 5(5) USA IHT DTT relates to nationality and treaty-domicile:

> An individual who was a resident (domiciliary) of a possession of the US and who became a citizen of the US solely by reason of his
> (a) being a citizen of such possession, or
> (b) birth or residence within such possession,
> shall be considered as neither domiciled in nor a national of the US for the purposes of this Convention.

I understand that the possessions of the US are mainly uninhabited islands[1] so not many (if any) individuals are affected by this provision.

1 Howland Island; Baker Island; Jarvis Island; Navassa Island; Johnston Atoll; Midway Islands; Palmyra Atoll; Wake Islands; Guantanamo Bay; Kingman Reef.

51.6 IHT exemptions for individuals

Article 5 USA IHT DTT provides two exemptions for individuals. Article 5(1) provides:

> (a) [i] Subject to the provisions of Articles 6 (Immovable Property (Real Property)) and 7 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Independent Personal Services) and the following paragraphs of this Article,
> [ii] if the decedent or transferor was domiciled in one of the Contracting States at the time of the death or transfer, property shall not be taxable in the other State.
> (b) Sub-para (a) shall not apply if at the time of the death or transfer the decedent or transferor was a national of that other State.

This can confer IHT exemption. To qualify for IHT exemption under Art. 5(1) the individual must be:

(1) treaty-domiciled in the USA and
(2) not a UK national.

Article 5(2) USA IHT DTT provides:

> Subject to the provisions of the said Articles 6 and 7, if at the time of the death or transfer the decedent or transferor
> [a] was domiciled in neither Contracting State and
> [b] was a national of one Contracting State (but not of both),
> property which is taxable in the Contracting State of which he was a national shall not be taxable in the other Contracting State.

Can this confer IHT exemption? In order to need and qualify for IHT exemption under art. 5(2):

(1) the individual must be:
  (a) treaty-domiciled in neither state (so in particular not UK domiciled or deemed domiciled) and
  (b) a US national and not a UK national
(2) property must be taxable in the UK (or no relief is needed) so it must be UK situate.

(3) the property must be taxable in the USA.

This is just possible. Condition (1) is possible because a US national is not necessarily treaty-domiciled in the USA. If such an individual held UK situate property, it would be exempt from IHT under Art. 5(2) provided it was taxable in the USA. In practice though this will be rare.

These two exemptions applies to charges on death and on lifetime gifts. The exceptions even apply to UK situate property (so long as the property is not land or a permanent establishment).

51.7 IHT exemption for trusts

Article 5(4) USA IHT DTT provides:

> [a] Paras (1) and (2) shall not apply in the UK to property comprised in a settlement;
> [b] but, subject to the provisions of the said Articles 6 and 7, tax shall not be imposed in the UK on such property if at the time when the settlement was made the settlor was domiciled in the US and was not a national of the UK.

Article 5(4)[b] provides exemption from:

(1) IHT 10 year and exit charges;
(2) the charge on the death of an individual with an estate IP;
(3) GW lifetime and death charges.

The exemption applies to UK situate property (so long as the property is not land or a permanent establishment).

It is an interesting question whether a common form grantor trust is a settlement for this purpose: it is a settlement for US purposes (I think) but not for IHT purposes.[2] It is also an interesting question whether or to what extent UK rules determining when a settlement is made (and who is the settlor) apply for the purposes of this relief.

2 See 62.4 (American grantor trust).

51.8 Requirement to pay foreign tax

Article 5(5) USA IHT DTT provides:

> If by reason of the preceding paragraphs of this Article
> [a] any property would be taxable only in one Contracting State and
> [b] tax, though chargeable, is not paid (otherwise than as a result of a specific exemption, deduction, exclusion, credit or allowance) in that State,
> tax may be imposed by reference to that property in the other Contracting State notwithstanding those paragraphs.

The IHT Manual provides:

> **27177. Certification of disclosure and tax enforcement procedure with the USA** {October 2007]
> Before we give up our rights to tax property in accordance with Article 5(1) of the DTC with the USA, we require the US authorities to certify that disclosure has been made to them and that payment of any appropriate tax has been made or will be enforced. This is because Article 5(5) of the DTC withdraws this restriction and allows us to tax the property if the USA is unable to enforce its right to tax. Conversely, we also need to certify to the above if the US authorities must give up their right to tax property.
> Cases in which para (1) operates to exclude some UK property from the charge to IHT and which are, or but for that exclusion would be, taxpaying should not be closed until the US authorities have certified on Form 742 that disclosure has been made to them and that payment of any appropriate tax has been made or will be enforced.
> This requirement should be explained to the taxpayer and 2 prints of Form 742 issued to them. Attention should be directed to the appropriate paragraphs of the form, which the taxpayer is required to complete. In particular where by reason of the Convention the UK is giving up its taxing rights, only para 1 is in point, and paras 2 to 7 are not appropriate. On receipt of a correct and duly certified form the case may be closed: any error or difficulty should be referred to TG.
> Where the USA gives up the right to tax property under Article 5(1), US form 706 CE will be forwarded to this Office in duplicate for certification.
> After checking (it is important that the forms themselves should not be marked in any way) they and the file should be sent with a note of any error or omission to TG for the issue of the appropriate certificate.

51.9 Dual-situate assets

Article 5(6) USA IHT DTT provides:

> If at the time of the death or transfer
> [a] the decedent or transferor was domiciled in neither Contracting State and
> [b] each State would regard any property as situated in its territory and
> [c] in consequence tax would be imposed in both States,
> the competent authorities of the Contracting States shall determine the situs of the property by mutual agreement.

This is not relevant if IHT exemption or US tax exemption applies. It is a different technique from dealing with the problem of dual-situate assets from that adopted in the pre-1974 treaties, which set out their own treaty-situs rules (as indeed the previous US estate duty treaty did.)

51.10 Immovable property

Article 6 USA IHT DTT provides:

> (1) Immovable property (real property) may be taxed in the Contracting State in which such property is situated.
> (2) The term "immovable property" shall be defined in accordance with the law of the Contracting State in which the property in question is situated, provided always that debts secured by mortgage or otherwise shall not be regarded as immovable property. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats, and aircraft shall not be regarded as immovable property.
> (3) The provisions of paras (1) and (2) shall also apply to immovable property of an enterprise and to immovable property used for the performance of independent personal services.

This is what one would expect.

51.11 Business property

Article 7(1) USA IHT DTT provides:

> Except for assets referred to in Article 6 (Immovable Property (Real

> Property)) assets forming part of the business property of a permanent establishment of an enterprise may be taxed in the Contracting State in which the permanent establishment is situated.

I do not set out the length provisions relating to permanent establishment here, since this will rarely arise.

51.12 Deductions

Article 8(1) USA IHT DTT provides:

> In determining the amount on which tax is to be computed, permitted deductions shall be allowed in accordance with the law in force in the Contracting State in which tax is imposed.

This seems unnecessary.

51.13 Extension of IHT spouse exemption

Under domestic IHT law, the usual IHT spouse exemption is restricted when the transferor is UK domiciled and the spouse is foreign domiciled.[3] Article 8 restricts the restriction. There are separate provisions for absolute transfers and for transfers to a trust under which the spouse has an IP. There is no relief for the situation where H has an interest in possession and on his death W acquires an interest in possession (where the IHT spouse exemption is sometimes available under s.49D IHTA 1984).

Civil partners are not mentioned (of course). One might perhaps construe spouse widely to include "civil partner" but only if US law treats civil partners like spouses (which I doubt).

51.13.1 *Relief for absolute inter-spouse transfers*

Article 8(3) USA IHT DTT provides:

> Property which passes to the spouse from a decedent or transferor who was domiciled in or a national of the US and which may be taxed in the

3 See 53.2 (Restriction on IHT spouse exemption for foreign domiciled spouse).

UK shall, where

(a) the transferor's spouse was not domiciled in the UK but the transfer would have been wholly exempt had the spouse been so domiciled, and
(b) a greater exemption for transfers between spouses would not have been given under the law of the UK apart from this Convention,

be exempt from tax in the UK to the extent of 50 per cent of the value transferred, calculated as a value on which no tax is payable and after taking account of all exemptions except those for transfers between spouses.

In order for this to be needed and to apply the following conditions must be satisfied:

The transferor is:

(a) Treaty-domiciled in the US or a US national.

(b) UK actually domiciled or deemed UK domiciled (or else the IHT spouse exemption is not restricted under IHT domestic law).

The transferee (spouse) is:

(a) not treaty-domiciled in the UK.

(b) not actually UK domiciled or deemed UK domiciled (or else the IHT spouse exemption is not restricted under IHT domestic law).

This relief applies on death and on lifetime transfers.

51.13.2 *Transfer to settlement under which spouse has IP*

Article 8(4) USA IHT DTT provides:

(a) Property which on the death of a decedent domiciled in the UK became comprised in a settlement shall, if the personal representatives and the trustees of every settlement in which the decedent had an interest in possession immediately before death so elect and subject to sub-para (b), be exempt from tax in the UK to the extent of 50 per cent of the value transferred (calculated as in para (3)) on the death of the decedent if:

(i) under the settlement, the spouse of the decedent was entitled to an immediate interest in possession,

(ii) the spouse was domiciled in or a national of the US,

(iii) the transfer would have been wholly exempt had the spouse been domiciled in the UK, and

(iv) a greater exemption for transfers between spouses would not have been given under the law of the UK apart from this Convention.

(b) Where the spouse of the decedent becomes absolutely and indefeasibly entitled to any of the settled property at any time after the decedent's death, the election shall, as regards that property, be deemed never to have been made and tax shall be payable as if on the death such property had been given to the spouse absolutely and indefeasibly.

In order for this to be needed and to apply the following conditions must be satisfied:

The transferor is:
(a) Treaty-domiciled in the UK.
(b) UK actually domiciled or deemed UK domiciled (or else the IHT spouse exemption is not restricted under domestic law).

The transferee (spouse) is:
(a) treaty-domiciled in the US or a national of the US.
(b) not actually UK domiciled or deemed UK domiciled (or else the IHT spouse exemption is not restricted under domestic law).

In addition:
(1) An election is required.
(2) The spouse must be entitled to an immediate IP (this probably rules out relying on s.144 IHTA (discretionary will trusts).
(3) This relief only applies on the death of the transferor.

51.14 Tax credits

Article 9 USA IHT DTT provides:

(2) Where under this Convention the UK may impose tax with respect to any

property other than property which the UK is entitled to tax in accordance with the said Article 6 or 7 (that is, where the decedent or transferor was domiciled in or a national of the UK), then, except in the cases to which para (3) applies, double taxation shall be avoided in the following manner:

(a) Where the US imposes tax with respect to property in accordance with the said Article 6 or 7, the UK shall credit against the tax calculated according to its law with respect to that property an amount equal to the tax paid in the US with respect to that property.

(b) Where the US imposes tax with respect to property not referred to in sub-para (a) and the decedent or transferor was a national of the UK and was domiciled in the US at the time of the death or transfer, the UK shall credit against the tax calculated according to its law with respect to that property an amount equal to the tax paid in the US with respect to that property.

(3) Where both Contracting States impose tax on the same event with respect to property which under the law of the US would be regarded as property held in a trust or trust equivalent and under the law of the UK would be regarded as property comprised in a settlement, double taxation shall be avoided in the following manner:

(a) Where a Contracting State imposes tax with respect to property in accordance with the said Article 6 or 7, the other Contracting State shall credit against the tax calculated according to its law with respect to that property an amount equal to the tax paid in the first- mentioned Contracting State with respect to that property.

(b) Where the US imposes tax with respect to property which is not taxable in accordance with the said Article 6 or 7 then

    (i) where the event giving rise to a liability to tax was a generation-skipping transfer and the deemed transferor was domiciled in the US at the time of that event,

    (ii) where the event giving rise to a liability to tax was the exercise or lapse of a power of appointment and the holder of the power was domiciled in the US at the time of that event, or

    (iii) where (i) or (ii) does not apply and the settlor or grantor was domiciled in the US at the time when the tax is imposed,

    the UK shall credit against the tax calculated according to its law with respect to that property an amount equal to the tax paid in the US with respect to that property. ...

(4) The credits allowed by a Contracting State according to the provisions of paras (1), (2) and (3) shall not take into account amounts of such taxes not levied by reason of a credit otherwise allowed by the other Contracting State. No credit shall be finally allowed under those paragraphs until the tax (reduced by any credit allowable with respect thereto) for which the credit is allowable has been paid. Any credit allowed under those paragraphs shall not, however, exceed the part of the tax paid in a Contracting State (as computed before the credit is given but reduced by any credit for other tax) which is attributable to the property with respect to which the credit is given.

(5) Any claim for a credit or for a refund of tax founded on the provisions of the

present Convention shall be made within six years from the date of the event giving rise to a liability to tax or, where later, within one year from the last date on which tax for which credit is given is due. The competent authority may, in appropriate circumstances, extend this time where the final determination of the taxes which are the subject of the claim for credit is delayed.

The IHT Manual provides:

27170. USA [October 2007]
Where a DT credit is due you may give a provisional allowance but the case must not be closed until the payment has been certified by the US authorities on Form 742.
You must send the taxpayer two prints of form 742 ask them to complete the forms and send them to the US authorities at the address given on the form. One of these copies is certified and returned to this office and the other is retained by the US authorities. The certified form must be checked and the appropriate credit allowed. If you have any difficulty applying the DTC or calculating the tax attributable to the property please seek advice from TG.

- The credit given cannot exceed the amount of tax payable in the UK on the property concerned.

Certification of IHT paid for the US authorities
The US form 706 CE is forwarded to this Office in duplicate for certification. After checking (it is important that the forms themselves should not be marked in any way) they and the file must be sent with a note of any error or omission to TG. If the case is closed TG arranges for one copy to be certified and sent with a schedule of any necessary amendments to the US authorities; the other copy is filed. The taxpayer is informed that the certificate has been sent and is provided with a copy of any amending schedule.
Where a certificate of tax paid cannot be issued on application because the amount of tax has not been finalised and paid, an explanation must be given to the taxpayer together with a reminder that it is open to them to lodge a provisional claim for a credit with the US authorities (there is a time limit – Article 9). When the case is ready for certification the application is referred with the file to TG to issue the certificate.
If there is any adjustment of tax after a certificate has been issued the file must again be referred to TG for the issue of an amending certificate.

51.15 Non-discrimination

Article 10(1) USA IHT DTT provides:

(a) Subject to the provisions of sub-para (b), nationals of a Contracting State shall not be subjected in the other State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which

> nationals of that other State in the same circumstances are or may be subjected.

This would extend IHT Agricultural property relief to US agricultural property, which could be relevant to companies holding agricultural land but the point will not often arise.

Article 10 continues:

> (2) The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.
> (3) Nothing contained in this Article shall be construed as obliging either Contracting State to grant to individuals not domiciled in that Contracting State any personal allowances, reliefs and reductions for taxation purposes which are granted to individuals so domiciled.
> (4) Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.
> (5) The provisions of this Article shall apply to taxes which are the subject of this Convention.

51.16 Other articles

The following articles of the USA IHT DTT are not discussed here:

Article 11:	mutual agreement procedure.
Article 12:	exchange of information.
Article 13:	preserving fiscal privileges of diplomatic or consular officials.
Article 14:	entry into force.
Article 15:	termination.

CHAPTER FIFTY TWO

IHT UNILATERAL RELIEF

52.1 IHT unilateral relief

Section 159(1) IHTA provides unilateral IHT relief:

> Where the Board are satisfied that in any territory outside the UK (an "overseas territory") any amount of tax imposed by reason of any disposition or other event is attributable to the value of any property, then, if—
> (a) that tax is of a character similar to that of capital transfer tax or is chargeable on or by reference to death or gifts inter vivos, and
> (b) any capital transfer tax chargeable by reference to the same disposition or other event is also attributable to the value of that property,
> they shall allow a credit in respect of that amount ("the overseas tax") against that capital transfer tax in accordance with the following provisions.

Section 159(6) IHTA defines "tax imposed":

> In this section references to tax imposed in an overseas territory are references to tax chargeable under the law of that territory and paid by the person liable to pay it.

The IHT Manual provides:

> **27185. Introduction** [October 2007]
> We can allow credit under Section 159 IHTA 1984 for tax paid this is called "unilateral" relief. ...

Under Section 159 IHTA 1984, credit can be allowed not only on death but also in respect of lifetime dispositions where some type of gift tax is charged in the foreign country. The basic conditions to be satisfied in connection with a lifetime or death transfer are that both Inheritance Tax and overseas tax must be chargeable by reference to the same event and attributable to the value of the same property, and that the foreign tax is similar in character to IHT. In cases of doubt, you must take advice from TG.

The amount of the credit allowed under Section 159 IHTA 1984 is the Sterling equivalent of the foreign tax paid (converted using the exchange rate on the date of payment) so far as that tax is attributable to the foreign property on which IHT has been paid. Any part of the sum paid to the foreign Revenue authorities representing interest or penalties should be excluded, as should any part of the foreign tax that is attributable to income accruing since the date of the transfer. The relief cannot exceed the amount of Inheritance Tax charged with respect to the particular item of property.

SAV (Foreign) will provide the exchange rate required.

Before relief can be finalised, the taxpayer must produce evidence of payment of the foreign tax in the form of the assessment of foreign tax (or other document showing details of the property charged) and the official receipt.

Once you decide on the amount of relief available this should be entered in the 'reliefs against tax' box in the appropriate 'raising an assessment' COMPASS screen. If necessary, the relief must be apportioned between the instalment and non-instalment option property assessments. (See IHTM31189)

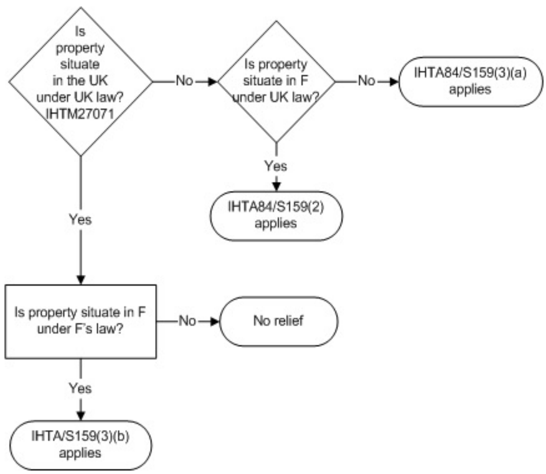
The relief cannot exceed the amount of Inheritance Tax charged with respect to the particular item of property.

No IHT can be treated as imposed on property comprised in a transfer, which by some provision is made wholly exempt from the tax. Where a transfer is partly exempt, any tax charged will be attributed to the chargeable part of the transfer of value. Thus any wholly exempt property cannot be regarded as taxed in both countries and any credit will be restricted accordingly.

Where Quick Succession Relief (IHTM22041) is allowed, the amount of IHT attributable to the property is the net amount after allowing the relief.

…

27186 Procedure chart



Relief should be given under Section 159(2) IHTA 1984 rather than Section 159(3)(a) where tax is paid, under an agreement between the provinces concerned, in Quebec or Ontario on shares which by UK law are situate in the other province. This applies also to a similar arrangement between Quebec and British Columbia.
Any case in which the parties seriously oppose the application of UK law, should be referred to TG (IHTM01081) or to your Team Leader in Scotland.

For the interaction of the USA IHT DTT and transferable nil rate bands, see 50.7 (Transferable nil rate bands and IHT double taxation reliefs).

52.2 Amount of credit

The amount of tax credit depends on

(1) situs of property under UK law and
(2) situs of property under the foreign law.

The IHT Manual provides at 27185 [October 2007]:

Because of the terms of Section 159(2), (3) and (4) IHTA 1984 it is necessary to consider the situs (IHTM27071) of property according to UK law and, possibly, according to a foreign law when allowing a credit for foreign tax. You must raise any questions necessary to establish the situs as soon as it seems likely that a Section 159 IHTA 1984 credit will be claimed.

52.2.1 *Situs in overseas territory*

Section 159(2) IHTA provides:

> Where the property is situated in the overseas territory and not in the UK, the credit shall be of an amount equal to the overseas tax.

The IHT Manual provides at IHTM127185 [October 2007]:

> **27187. Relief under Section 159(2) IHTA 1984**
> Where the property concerned is situate (under UK law) in the foreign country, relief is due under Section 159(2) IHTA 1984 and the credit due is equal to the foreign tax paid.
> In practice, the credit cannot exceed the IHT attributable to the property concerned.

More accurately, the *credit* (as defined) can exceed the IHT attributable to the property, but this credit is only set against the IHT attributable to the property, so the amount of the relief is the lesser of the credit and that IHT. The IHT Manual goes on to give an example:

> *Example*
> B died in September 2002, leaving an apartment in Spain valued at £50,000. B's total estate amounts to £300,000 (there were no lifetime gifts), with total IHT payable of £20,000.
> The Spanish authorities charge tax equivalent to Sterling £4,000 on the apartment on B's death.
> The IHT payable on the apartment is:
> £50,000 × (£20,000/£300,000) = £3,333.33
> Accordingly, the double taxation credit due under Section 159(2) IHTA 1984 is restricted to £3,333.33.

52.2.2 *Situs in third country or dual situate property*

Section 159(3) IHTA provides:

> Where the property—
> (a) is situated neither in the UK nor in the overseas territory, or
> (b) is situated both in the UK and in the overseas territory,
> the credit shall be of an amount calculated in accordance with the

following formula—

$$\frac{A}{A + B} \text{ x C}$$

where
A is the amount of the capital transfer tax,
B is the overseas tax and
C is whichever of A and B is the smaller.

The IHT Manual provides at IHTM127185 [October 2007]:

27188. Relief under Section 159(3) and Section 159(4) IHTA 1984 [Sept 2008]

- Relief is due under Section 159(3) IHTA 1984 where the UK and another foreign country tax the same property and that property is situate: neither in the UK nor in the foreign country, or
- both in the UK and in the foreign country.

Where relief is due under Section 159(3) IHTA 1984, it is given on a split credit basis and will be less than the foreign tax paid. [The Manual sets out the formula in s.159(3) and continues:]

Example 1

Country X and the UK tax an item of property which is situate neither in Country X or UK.

Country X charges tax of £40
UK charges IHT of £60

The credit is: 60/(60 + 40) × (40) = £24

52.2.3 *Property taxed in more than one foreign country*

Section 159(4) IHTA provides:

Where tax is imposed in two or more overseas territories in respect of property which—

(a) is situated neither in the UK nor in any of those territories, or
(b) is situated both in the UK and in each of those territories,
subsection (3) above shall apply as if, in the formula there set out,

B were the aggregate of the overseas tax imposed in each of those territories and
C were the aggregate of all, except the largest, of A and the overseas tax imposed in each of them. ...

The IHT Manual provides an example at IHTM127185 [October 2007]:

Example 2
Each of Country X, Country Y and the UK tax an item of property which is not situate in Country X, Country Y nor the UK.
Country X charges £40
Country Y charges £20
UK charges IHT of £60
The credit is 60/(60+40+20) X (40 + 20) = £30

52.2.4*Interaction of s.159(2)(3)*

Section 159(5) IHTA deals with the interaction of the two reliefs:

> Where credit is allowed under subsection (2) above or section 158 above in respect of overseas tax imposed in one overseas territory, any credit under subsection (3) above in respect of overseas tax imposed in another shall be calculated as if the capital transfer tax were reduced by the credit allowed under subsection (2) or section 158; and where, in the case of any overseas territory mentioned in subsection (3) or (4) above, credit is allowed against the overseas tax for tax charged in a territory in which the property is situated, the overseas tax shall be treated for the purposes of those provisions as reduced by the credit.

The IHT Manual provides:

> If relief is due under Section 159(3)(a) IHTA 1984 or Section 159(4)(a) IHTA 1984, Section 159(5) IHTA 1984 must be considered when calculating the foreign tax paid (B in the formulas above). If the foreign country has allowed a credit against its tax for tax paid in another foreign country, please refer to TG.
> Where relief is due under Section 159(3)(b) IHTA 1984 or Section 159(4)(b) IHTA 1984, above, the foreign tax at B is simply the gross amount paid – no account need be taken of any credit for tax paid in another country.
> **27189. Procedure when both Section 159(2) and Section 159(3) IHTA 1984 apply**
> It may happen that relief is due under both Section 159(2) IHTA 1984 – or convention relief under Section 158 IHTA 1984 – and under Section 159(3) IHTA 1984.
> If this is the case, Section 159(5) states that the credit allowed under Section 159(3) must be calculated on the basis that A in the formula (the Inheritance Tax paid) is the net amount of Inheritance Tax after allowing the credit under Section 158 or Section 159(2)
> …

52.2.5 *Interaction of unilateral relief and DTT relief*

Section 159(7) IHTA provides:

> Where relief can be given both under this section and under section 158 above [double tax treaties], relief shall be given under whichever section provides the greater relief.

The IHT Manual provides:

> **27200. Procedure when both forms of relief apply**
> Unilateral relief and relief under a DTC **are not mutually exclusive. Where both reliefs are prima facie due with reference to the same item of property, relief is restricted by Section 159(7) IHTA 1984 to whichever is the greater. In practice, where the amount of credit is the same under either basis, the credit should be treated as Convention relief.**
> In cases where, either;
> - (a) both reliefs are due, but the unilateral relief appears the greater or
> - (b) the interaction of the two reliefs gives rise to undue difficulty.
>
> You must refer the case to TG (IHTM01081). In Scotland, your Team Leader should be consulted in cases of difficulty.
> **Unilateral relief may be given for a State tax in addition to unilateral or Convention relief in respect of tax levied by the country of which the State forms part.**
> *Example*
> Deceased, a British citizen, dies domiciled in the UK. His estate includes an apartment in New York, stocks and shares in US Companies and a New York bank account.
> The world-wide estate will be subject to UK tax, but US Federal Estate Tax will (because of the terms of the DTC) be payable only on the immovable property in the USA. The UK will give credit for the US tax under the DTC.
> NY State will also charge State Estate Tax on the movable assets situate there and the UK will give unilateral relief for this tax.
> But the total unilateral and convention credit cannot exceed the amount of UK IHT payable on the property concerned.

52.3 Concession for UK situate property

The IHT Manual provides:

> **27201. Procedure for relief by concession on shares**
> Occasionally shares in a company, although situated in some part of the UK by UK law, are also treated as liable to tax in a foreign country on the grounds, for example, that the company carries on business there. In this circumstance, by

concession the amount of foreign tax is allowed as a deduction against the value of the shares. This concession operates whether the company is incorporated in the UK or elsewhere.

The concession applies in the same way where the obligation to pay foreign tax on death falls upon the company and the company has the right to be reimbursed by the personal representatives of the deceased shareholder before it registers a transfer of the shares.

The concession does not apply to cases covered by the statutory reliefs provided for by Section 158 IHTA 1984 and Section 159 IHTA 1984. Nor does it apply to shares that become liable to the foreign tax by reason of the operation of a Double Taxation Convention to which the UK is not a party.

In certain circumstances, concessionary relief against the value of property is allowed in respect of taxes payable in the Republic of Ireland (IHTM28101) and in Canada (IHTM28102).

52.4 Planning

The rule that the relief is the lesser of (1) foreign tax and (2) UK tax attributable to the same property means that careful planning is needed to maximise the benefit of the relief. It can easily be lost or wasted.

Suppose T owns land in country X which on his death will bear IHT in country X. If T makes a chargeable gift of the land (eg a gift to his children) then the foreign tax credit is available. If T makes an exempt gift (eg to his spouse or to charity) the foreign tax credit is lost. For instance, suppose T is considering giving a French home to a UK charity. The gift will bear French death duties at a rate which is greater than the rate of UK IHT so the gift is effectively exonerated from IHT. It will therefore make more sense to make a gift of the French home which is chargeable under UK law.[1] T should give to the UK charity, say, UK residential accommodation, which would otherwise bear inheritance tax at the full rate. In some cases the matter could be put right by a deed of variation.

1 The position is complicated further by the French rules which make the rate of succession duty depend on the relationship of the beneficiary to the deceased. It would therefore pay, so far as possible, to devise French realty to those who would pay the least French tax, reducing their share of UK assets accordingly. French forced heirship rules also need to be considered.

CHAPTER FIFTY THREE

UK DOMICILIARY MARRIED TO FOREIGN DOMICILIARY

53.1 UK domiciliary married to foreign domiciliary – Introduction

This chapter considers the position of a UK domiciled individual who is married to a foreign domiciled spouse.[1] It is necessary to consider the various taxes separately.

53.2 Restriction on IHT spouse exemption for foreign domiciled spouse

Section 18(1) IHTA normally provides complete exemption for transfers between spouses.[2] Section 18(2) imposes an important exception:

> If, immediately before the transfer, the transferor but not the transferor's spouse or civil partner is domiciled in the UK the value in respect of which the transfer is exempt (calculated as a value on which no tax is chargeable) shall not exceed £55,000 less any amount previously taken into account for the purposes of the exemption conferred by this section.

So where:

(1) the transferor is UK domiciled (or deemed UK domiciled), and
(2) the transferee (the spouse of the transferor) is foreign domiciled

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1 References to "spouse", "marriage", and "widow/ers" include a civil partner, civil partnership and a surviving civil partner. See Appendices 1.2 (Meaning of spouse) and 1.3 (Civil partners).

2 For the interaction of the IHT spouse exemption and excluded property rules, see 49.2 (IHT spouse exemption on death of a foreign domiciliary).

the exemption is restricted to £55,000 only.[3] While it is generally true that a foreign domicile is a passport to tax saving, this is one circumstance in which a foreign domicile is a serious drawback.

This restriction does not apply the other way round, where the foreign domiciled individual makes a transfer to his UK domiciled spouse. (Nor should it apply in those circumstances because such a transfer brings assets which would have been outside the realm of IHT within its scope.)

The restriction does not apply where both spouses are not domiciled in the UK.

The restriction may be modified by double tax treaties if a spouse is domiciled in an appropriate treaty country.[4]

Transfers which do not qualify for the spouse exemption will be PETs unless some other exemption is in point.

One solution to this problem may be to wait until the foreign domiciled spouse becomes deemed UK domiciled.[5]

Where the foreign domiciled spouse is a citizen of another member state, the discrimination is unlawful in EU law. The government justify the discrimination on the grounds of the "potential avoidance risk".[6] But that is not sufficient to justify discrimination.

53.2.1 *Interaction of £55,000 spouse exemption and other exemptions*

An inter-spouse gift within the £55,000 limit is *not* a PET. Section

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3 The IHT Manual states at IHTM11033 [October 2007]:

"The £55,000 limit applies to

- the value before grossing (IHTM26121)
- the cumulative total of all transfers to a spouse, or spouses, or civil partner domiciled outside the UK. So you should take into account the amounts allowed under earlier transfers in which the IHTA84/S18 (2) limitation applied in considering whether the £55,000 is exceeded
- transfers on or after 9 March 1982. For transfers before that date the limit was lower, and you should refer to the Taxes Acts 1982 Edition held in the library

Where the £55,000 limit is exceeded, you should allocate the exemption in the manner which is most favourable to the spouse or civil partner. Factors you should bear in mind include the incidence of tax and the availability of business relief (IHTM24131), agricultural relief (IHTM24001) or other reliefs."

4 See 51.13 (Extension of IHT spouse exemption).

5 See 43.2 (Deemed UK domicile)

6 Public Bill Committee debate on Finance Bill, Hansard 13 May 2008 col.181.

3A(1A)(b) IHTA provides that a PET is a transfer of value "which, apart from this section, would be a chargeable transfer".[7] So if one spouse makes a gift to the other, that gift uses up the lifetime £55,000 limit even though the gift is made more than seven years from the death and would otherwise qualify as an exempt transfer, as a PET.

The position is different for a gift of excluded property.[8] Such a gift is not a transfer of value at all and therefore it is not a transfer which qualifies for the spouse exemption and does not use up the £55,000 exemption.

The position is less clear for a transfer (outside s.11) which qualifies for the annual or normal expenditure exemptions. Such a transfer is an exempt transfer under those exemptions: does it also use up the £55,000 limit for inter-spouse gifts? There is no clear answer in the legislation but it is suggested that these transfers do not use up the £55,000 limit. That would seem to better fit the scheme of the legislation.

See 49.2 (IHT spouse exemption on death of a foreign domiciliary); 49.3 (Drafting will of foreign domiciliary); and 45.8 (GWR spouse exemption).

53.3 Exemption when spouse or widow of settlor becomes entitled to settled property

The termination of an estate interest in possession (during the life of the life tenant) is a transfer of value under s.52 IHTA. Section 53(4) IHTA provides:

> Tax shall not be chargeable under s.52 above if on the occasion when the interest comes to an end—
> (a) the settlor's spouse or civil partner, or
> (b) where the settlor has died less than two years earlier, the settlor's widow or widower or surviving civil partner,
>
> becomes beneficially entitled to the settled property and is domiciled in the UK.[9]

This relief only applies if the spouse is UK domiciled. The restriction on

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7 Transfers before 22 March 2006 are governed by s.3A(1) IHTA but the wording on this point is the same.

8 Likewise a gift within s.11 IHTA; see 53.4 (Disposition for maintenance of spouse and other exemptions).

9 Section 53 goes on to set out some exceptions not discussed here.

s.53(4) relief is broadly consistent with the restriction to the spouse exemption considered above (and indeed this or something similar is necessary to prevent avoidance of the restriction on s.18 relief).

Section 54(2) IHTA sets out similar rules for the termination of an estate interest in possession on the death of the life tenant.

53.4 Disposition for maintenance of spouse and other exemptions

Where the IHT spouse exemption does not apply, another exemption may sometimes fill the gap. An inter-spouse gift may qualify for relief under s.11(1) IHTA:

> A disposition is not a transfer of value if it is made by one party to a marriage[10] or civil partnership in favour of the other party ... and is—
> (a) for the maintenance of the other party ...[11]

This should normally[12] apply, in particular, to the common case where an individual gives a half share in the family home to his spouse. The most basic requirement of "maintenance" is to have a secure roof over one's head.[13] In *Phizackerley v IRC*[14] the Special Commissioners correctly stated that the normal reason for such a gift is to give the donee spouse security in her own home. Unfortunately he concluded that it was not "for the maintenance" of the other party, it was to give the other party security. With respect, this can hardly be right, because "security" and "maintenance" are not alternatives. It is because the gift gives the spouse security that it is for her maintenance. But it will now be necessary to appeal to the High Court to establish this point.

A gift which is within s.11 IHTA (Disposition for family maintenance)

10 "Marriage" is defined to include a former marriage in certain cases: s.11(6) IHTA.

11 I mention for completeness the further relief in s.11(3) which overlaps with s.11(1). In practice an inter-spouse gift which qualifies under s.11(3) will also qualify under s.11(1).

12 It would be different if the purpose of the gift was not to provide for the spouse but some other purpose, such as IHT planning.

13 Lump sum payments can constitute "maintenance". Contrast s.2(1)(b) Inheritance (Provision for Family and Dependants) Act 1975 (formerly s.1(4) Inheritance (Family Provision) Act 1938) which states that lump sum payments may constitute "maintenance" for the purpose of the Act. This is also assumed in Sch 15 para 10(1)(d) FA 2004 (which takes gifts within s.11 out of the pre-owned assets rules).

14 [2007] UKSPC SPC 00591.

is outside the scope of the GWR rules. For such a disposition is not a transfer of value; so it is deemed not to reduce the transferor's estate: s.3 IHTA. So by implication it must be treated as not being a "disposal by way of gift". (Any other conclusion would lead to absurd results. For a disposition between spouses within s.11 is not a transfer of value, and so not within the IHT spouse exemption, and so would come within the GWR rules even if both spouses were UK domiciled.)[15]

The normal expenditure exemption (s.21 IHTA) may also be in point. Gifts which qualify for this exemption are still within the reservation of benefit rule.

53.5 Transferable nil-rate bands

The IHT Manual provides:

> **IHTM43042 Transferable Nil rate Band : domicile of first spouse or civil partner to die**
> Every person, UK domiciled or not, is entitled to the full nil rate band that can be set against their estate that is subject to IHT.
> The availability of TRNB on the estate of the first to die of a non domiciled spouse or civil partner is calculated only by reference to property that is potentially subject to an UK IHT charge. For a non domiciled spouse or civil partner, **VT** [IHTM43020] will be calculated only by reference to their estate in the UK. Assets held outside the UK, by a person not domiciled, or deemed domiciled in the UK, regardless of the devolution of those assets are not taken into account when calculating the available unused nil rate band.
> Thus where the survivor dies in the UK and their spouse or civil partner, who held no UK assets, died abroad leaving all their all overseas assets to their children, none of the nil rate band was used on the first death and the personal representatives of the survivor may claim to transfer 100% of the nil rate band to the estate of the survivor.
> *Example*
> The deceased died domiciled abroad. His only asset situated in the UK was a US dollar account containing US$250,000. He left this and the remainder of his estate to his son who lives in the UK. After the death, his widow moved to UK to live with her son and died domiciled in the UK.
> The assets situated outside the UK are not liable to IHT. The US dollar account is left out of account [IHTM04380]. So although whole estate passed to his son,

15 If my view were wrong the further anomaly would arise that gifts of qualifying investments to charity would fall within the scope of GWR, because such gifts fall within s.12 IHTA and not s.102(5)(d) FA 1986; but it is not necessary to pursue that here.

no property was chargeable to IHT, leaving the nil rate available for transfer in full on the widow's death.

IHTM43043 Transferable Nil rate Band : calculation where the domicile of the survivor at the first death is outside the UK

On the death of the first spouse or civil partner, exemption for assets passing to the surviving spouse or civil partner may be limited to £55,000 in accordance with s18(2) Inheritance Tax Act 1984 as the surviving spouse or civil partner was not domiciled or deemed domicile the UK [IHTM11033]

If the entire estate passed to the surviving spouse or civil partner, anything over £55,000 is a chargeable legacy. Where the net estate is above the nil rate band plus £55,000 there will be no nil rate band to transfer, as illustrated below.

Example

First death in 02/03		S8A(2) calculation	
Net estate	450,000	M =	250,000
Exempt under s18	55,000	VT =	395,000
Chargeable residue	395,000	M > VT by	Nil

Where the net estate is less than the nil rate band plus £55,000, there will still be an amount of nil rate band available to transfer. This example shows how both the amount that the net estate is below the nil rate band, and limited spouse exemption combine to produce the amount of nil rate band available to transfer.

Example

First death in 02/03		S8A(2) calculation	
Net estate	200,000	M =	250,000
Exempt under s18	55,000	VT =	145,000
Chargeable residue	145,000	M > VT by	105,000

S8A(4) IHTA calculation

E (M > VT) =	105,000
NRBMD =	250,000

Percentage (105,000 ÷ 250,000) x 100 = 42%

On the survivor's death in 2007/08, the nil rate band available on death would be

£300,000 + (£300,000 x 42%) = £426,000

This approach will be appropriate on the death of the survivor when either

- they remain domiciled abroad and their UK assets exceed the single nil rate band, or
- between the first death and their own, they became domiciled, or deemed domiciled in the UK.

53.6 Inter-spouse gift of 100% BPR or APR property

This section considers a gift of property qualifying for 100% business or agricultural property relief from a UK domiciled individual to his non-UK domiciled spouse. It is necessary to consider IHT on the gift and the gift with reservation rules. For convenience I refer to "business property" but similar rules govern agricultural property.

53.6.1 *IHT on the gift*

In the normal case of a gift of property qualifying for 100% BPR, the value transferred by the gift is nil. However, s.113A IHTA provides:

> **Transfers within seven years before death of transferor**
> (1) Where any part of the value transferred by a potentially exempt transfer which proves to be a chargeable transfer would (apart from this section) be reduced in accordance with the preceding provisions of this Chapter, it shall not be so reduced unless the conditions in subsection (3) are satisfied.

The conditions which must be satisfied are set out in subsection (3):

> The conditions referred to in subsections (1) and (2) above are—
> (a) that the original property was owned by the transferee throughout the period beginning with the date of the chargeable transfer and ending with the death of the transferor; and
> (b) except to the extent that the original property consists of shares or securities to which subsection (3A) below applies that, in relation to a notional transfer of value made by the transferee immediately before the death, the original property would (apart from s.106 above) be relevant business property.

In brief, BPR is lost unless the property is retained by the donee for seven years. (There is an exception for replacement property which is not discussed here.)

53.6.2 *GWR on the gift if the donor survives seven years*

What about GWR? The position varies according to whether or not the donor survives seven years from the gift.

If the donor does survive seven years then s.113A has no application. By subsection (1) it applies to a PET *which proves to be a chargeable transfer*. If the donor survives seven years then the PET does not "prove to be a chargeable transfer". Accordingly the value transferred by the gift remains at nil. The gift therefore normally qualifies as an exempt transfer under:

(1) s.20 IHTA (small gifts); or
(2) s.18 IHTA (IHT spouse exemption).

The gift therefore falls outside the scope of the GWR rules by virtue of s.102(5) FA 1986.

The principle applies to:

(1) outright gifts of 100% BPR property whether or not to spouses;
(2) gifts to trusts under which the spouse has an interest in possession even if such gifts are not "outright gifts" (but consider s.102(5A)).

It does not matter that the property is sold or disposed of by the donee within the seven years as long as the donor has survived seven years. Section 113A(7A) IHTA provides:

> The provisions of this Chapter for the reduction of value transferred shall be disregarded in any determination for the purposes of this section of whether there is a potentially exempt or chargeable transfer in any case.

This is irrelevant because the disregard is only for the purposes of s.113A, not for the purposes of ss.18, 20 IHTA and s.102 FA 1986.

53.6.3 *GWR if donor dies within seven years*

The position is different if the donor dies within seven years. Suppose:

(1) H (UK domiciled) gives 100% BPR property to W (foreign domiciled);
(2) H dies within seven years;
(3) the conditions in s.113A(3) are not satisfied (for instance the property has been sold[16] or disposed of by the donee).

In that case the value transferred is *not* reduced: s.113A(1). It is considered that the disallowance of BPR applies for all purposes of IHT.

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16 Though there is a possibility of reinvestment relief in this case: see s.113B IHTA.

So the gift falls outside the protection of ss.18 and 20 IHTA (assuming the value transferred exceeds the limits of £55,000 and £250 respectively) and the GWR provisions can in principle apply.

It is impossible to believe anybody actually thought through these rules at the time the legislation was enacted. But these are the consequences of the words used and the result, if a little complicated, is relatively sensible.

53.7 Divorce settlement between foreign domiciled and UK domiciled spouse

Suppose:

(1) H transfers assets to W in order to settle a divorce claim, and
(2) The disposition falls outside the IHT spouse exemption.[17]

No IHT charge arises. First, the disposition is not a transfer of value, if made under court order.[18] Second, s.10 IHTA provides:

> **Dispositions not intended to confer gratuitous benefit**
> (1) A disposition is not a transfer of value if it is shown that it was not intended, and was not made in a transaction intended, to confer any gratuitous benefit on any person and either—
> (a) that it was made in a transaction at arm's length between persons not connected with each other, or
> (b) that it was such as might be expected to be made in a transaction at arm's length between persons not connected with each other.

H does not normally intend to confer any "gratuitous benefit" on W. (Assume the divorce settlement is negotiated at arm's length.) Accordingly the disposition falls within s.10 IHTA and is not a transfer of value for IHT purposes.

There is a theoretical HMRC argument that the condition in s.10(1)(b) IHTA is not satisfied. The argument would be that a divorce settlement cannot be "such as might be expected to made in a transaction at arm's

17 This may be because H is UK domiciled and W is not; or because the transfer is made after the marriage is dissolved.

18 See *McCutcheon on IHT*, 4th ed, para 2.54. Relief may also be available under s.11 IHTA; see 53.4 (Disposition for maintenance of spouse and other exemptions).

length between persons not connected with each other" since persons not connected with each other would not be in a divorce situation. In my view this argument is not correct. It is the old question of how far one carries the fiction of a deeming provision. The argument carries it too far because it reaches a conclusion which does not fit in with the scheme of the IHTA. IHT Manual (while not explicit) suggests that HMRC do not take the point.[19]

53.8 Joint accounts

53.8.1 *Introduction*

This section considers a joint bank or building society account held by two account holders. I refer to money in the account as "account money".

There is an important distinction between:

(1) an account on which either account holder can draw a cheque;
(2) an account on which both account holders must sign a cheque.

This book only considers the first type of account.

53.8.2 *The property law background*

First of all one must ascertain the rights of the account holders. It would need a chapter to analyse the relevant case law.[20] In outline, three distinct questions arise, and the possible answers to them are as follows:

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19 IHTM 4165 [June 2006]: "Dispositions made on divorce or dissolution of a civil partnership (IHTM11032) for the benefit of a former spouse or civil partner, whether under a Court Order or as a result of arm's length negotiations, are normally within s.10 IHTA 1984."

20 For a summary see *Dymond's Capital Taxes*, para 10.400 and "Cohabitation: the financial consequences of relationship breakdown" Law Com No 307, July 2007, para A.46, accessible *www.lawcom.gov.uk/docs/lc307.pdf*.
Further consideration is needed for an account not governed by English law (but an English court will assume English law principles apply in the absence of evidence to the contrary). English law principles apply in Ireland: *Lynch v Burke* ITR Vol 5 p.271.

(1) *Beneficial ownership of the account money while in the account.* The possibilities are:
  (a) Entitlement in equal shares (the most common case)
  (b) Entitlement in proportion to contributions and withdrawals[21]
  (c) One account holder beneficially entitled to the whole.

(2) *Beneficial ownership of money withdrawn from the account* (or assets purchased with that money). The possibilities are:
  (a) Individual who withdraws funds becomes beneficial owner (the most common case)[22] or
  (b) same as beneficial ownership of the account money (as to which see above).

(3) *Beneficial ownership of account money on death of an account holder.* The possibilities are:
  (a) The survivor is beneficially entitled by survivorship.
  (b) The deceased owner's share (as to which see (1) above) passes under his will or intestacy.

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21 In practice the court will assume this is not the case unless there is evidence, such as appropriate records kept by the account holders. John Avery Jones gives cogent reasons for rejecting this analysis for the parent/child account in *Sillars v IRC* [2004] STC (SCD) 180, at [11].

22 See *Re Bishop* [1965] Ch 450 at p.456:

> "Where a husband and wife open a joint account at a bank on terms that cheques may be drawn on the account by either of them, then, in my judgment, in the absence of facts or circumstances which indicate that the account was intended, or was kept, for some specific or limited purpose, each spouse can draw upon it not only for the benefit of both spouses but for his or her own benefit. Each spouse, in drawing money out of the account, is to be treated as doing so with the authority of the other and, in my judgment, if one of the spouses purchases a chattel for his own benefit or an investment in his or her own name, that chattel or investment belongs to the person in whose name it is purchased or invested: for in such a case there is, in my judgment, no equity in the other spouse to displace the legal ownership of the one in whose name the investment is purchased. What is purchased is not to be regarded as purchased out of a fund belonging to the spouses in the proportions in which they contribute to the account or in equal proportions, but out of a pool or fund of which they were, at law and in equity, joint tenants. It also follows that if one of the spouses draws on the account to make a purchase in the joint names of the spouses, the property purchased, since it is purchased in joint names, is, prima facie, joint property and there is no equity to displace the joint legal ownership. There is, in my judgment, no room for any presumption which would constitute the joint holders as trustees for the parties in equal or some other shares."

The answer to one of these three questions does not determine the answers to the others. For instance, account money may belong beneficially to one of the account holders, e.g. H and W may hold as nominees for H. Such an account may be held on terms that:

(a) on the death of H, the account money passes to W by survivorship;[23] or
(b) the account money may pass under the will of H.

The permutations are almost endless. Note that joint tenancy/tenancy in common is not a comprehensive categorisation since those two terms alone are insufficient to determine the answers to the three questions which may arise.

The property law questions depend on the intention of the account holders. In practice spouses and cohabitees generally operate joint accounts without giving any consideration to the ownership of the money, except a general desire to share assets. A search for intention is unrealistic, and the fallback position is that:

(1) Account money is beneficially owned in equal shares.
(2) Withdrawals belong to the account holder who withdraws the funds.
(3) Beneficial ownership passes by survivorship.

I refer to this as a **"common form account".**

The circumstances in which parent/child joint accounts arise are different so the rights of the account holders tend to be materially different. For instance, the terms of the account may be that:

(a) One account holder ("P") may withdraw up to the whole amount of his benefit and the others may make no withdrawal at all during P's lifetime.
(b) The balance may pass to the survivor by survivorship.

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23 As in the parent/child joint account *O'Neill v IRC* 1998 STC (SCD) 110; the apparent breach of the Wills Act 1837, and the possibility that this is a settlement for IHT, are tacitly ignored.

In this case the fund is in the estate of P for IHT purposes: s.5(2) IHTA.[24] The funds are not in the estate of the other holders during the life of P: their rights have no substantial value. The following analysis applies to a common form account.

53.8.3 *Account money in estate of both account holders*

In strict law the *whole* of the account money is in the estate of both account holders, under s.5(2) IHTA which provides:

> A person who has a general power which enables him, or would if he were sui juris enable him, to dispose of any property other than settled property, ... shall be treated as beneficially entitled to the property ... and for this purpose "general power" means a power or authority enabling the person by whom it is exercisable to appoint or dispose of property as he thinks fit.[25]

Beneficial ownership is therefore irrelevant and GWR is irrelevant on death of an account holder.

53.8.4 *Payment into joint account by one account holder*

Payment into the joint account by an account holder is not a transfer of value because the estate of the payor is not decreased. HMRC agree. The IHT Manual provides:

> **15043 - The extent of the claim (England, Wales and Northern Ireland): lifetime gifts arising out of a transfer of an account into joint names**

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24 This was found to be the case on the facts in *Sillars v IRC* [2004] STC (SCD) 180.

25 This was accepted without discussion in the Court of Appeal in *IRC v Melville* 74 TC 372 at [36]:

> "... the inheritance tax regime produces instances of double taxation which are not limited to the circumstances specified in s 48. A clear example is one falling within s 5(2) of the Act, the very common case of a joint bank account which permits any holder to draw on that account. The same property, the moneys in the account, is under s 5(2) taxable on the death of each holder. The Revenue in practice do not strictly enforce that provision and treat each holder as beneficially entitled only to the proportion of monies in the account which he has contributed".

> [October 2007]
> Where A places money in a joint account (IHTM15042) in the names of A and B as joint tenants (IHTM15082) and retains the right to withdraw the whole of it, as a general rule there will not be a lifetime transfer (IHTM15060) at the time the money is paid into the account.

Payment into the joint account by an account holder is not a GWR. HMRC do not accept that[26] but in practice GWR does not often matter.

53.8.5 *Death of an account holder*

Either account holder is strictly subject to IHT on death on the whole of the account money (subject to exemptions such as the spouse exemption.) This rule results in double taxation which is undone by concession. The IHT Manual provides:

> **15042 - The extent of the claim (England, Wales and Northern Ireland): Joint money accounts** [June 2006]
> Application of the inheritance tax provisions (IHTM15012) to joint accounts can be particularly difficult. In practice
> - you should normally regard each account holder as beneficially entitled (IHTM15011) to the proportion of the account which is attributable to his contributions. Thus, if the deceased provided the whole of the money, the whole of the account at death should be included in the IHT 200

26 IHT Manual para 15061 is garbled; so far as relevant it provides:

> **"Gifts with reservation** [October 2007]
> An example of a joint ownership arrangements involving a GWR is ... if ... A transfers ... a joint money account into joint beneficial ownership of himself and his son, and then A either
> - receives (or has the right to receive) all the ... interest for his own benefit or
> - has the right to withdraw all the money in the joint account for his own benefit."

Presumably the manual means to say that there is a GWR if A transfers *his money* into a joint account and has the right to withdraw all the money. This view is supported by *Sillars v IRC* [2004] STC (SCD) 180 (where the taxpayer was not represented by counsel). But it is considered that a payment into an account of this kind is not a disposal by way of gift. If it were a GWR, many difficulties arise which the Tribunal did not consider in *Sillars*. On the death of A, however, since the property is in the estate of the individual, it does not matter whether payment into the account was a GWR.

(IHTM10021)

- in calculating this proportion you should assume that the drawings out by each should be set as far as possible against his own contributions, notwithstanding the rule in *Clayton's Case* [1816] 1 Mer 572
- it may be appropriate to enquire about any withdrawals made at the deceased's expense by the other joint owner(s) as these are likely to be lifetime transfers (IHTM15043). Look particularly critically at joint accounts opened shortly before death.
- it is common for each joint owner to have an unrestricted right to withdraw any part of the amount standing to the credit of the account and retain the withdrawal for his or her own use (for example, see *Re Bishop* [1965] Ch 450). *You should not use this right of withdrawal to claim tax (for example, by reference to the definition of 'property' in s.272 IHTA or the 'general power' provision in s.5(2) IHTA) on a share of the account greater than that which results from the practice outlined above.*

When raising a claim based on the deceased's contributions you should note that the true legal position is far from clear and, accordingly, it is vital to establish the facts and any relevant documents, e.g. application forms, withdrawal mandates, passbooks, terms and conditions of account etc. before considering the legal and equitable rules. Where the account holder has a joint account governed by Scots Law see IHTM15051 and IHTM15054.

53.8.6 *Spouse exemption on death of account holder.*

There are two possibilities:

(1) The account holders may not qualify for the spouse exemption because
  (a) They are married but one is, and one is not, UK domiciled.[27] (This scenario is relevant to the subject of this book, but one cannot examine it in isolation from the others.)
  (b) They are cohabitees
  (c) There is some other unmarried relationship, such as parent and child.
(2) The account holders may qualify for the IHT spouse exemption.

In the second case, the IHT spouse exemption may apply to the transfer of value on the death of an account holder. HMRC agree. The Manual passage continues:

27 In this section I ignore the limited £55k spouse exemption.

> Refer to TG (IHTM01081) any case in which the parties dispute the claim. However, there is no need to refer if the deceased's interest passes to an exempt beneficiary, such as a surviving spouse or civil partner (IHTM11032). You should also avoid questions and arguments on this subject unless the amount of tax at stake is substantial.

This is correct, though it needs a slightly purposive construction to say that property "becomes comprised" in the estate of the surviving spouse when the property is already in that estate.

53.8.7 *One account holder pays in and other withdraws money*

Suppose:

(1) A transfers his money into the joint account held by A and B and
(2) B withdraws that money into his own name,

A's estate is reduced at stage (2). A does not make a transfer of value at stage (2) within the normal definition, as that requires a disposition and A does not make a disposition.

One might think that A makes a transfer of value by omission under s.3(3) IHTA. This provides:

> Where the value of a person's estate is diminished, and the value—
> (a) of another person's estate, or
> (b) of any settled property, other than settled property treated by s.49(1) below as property to which a person is beneficially entitled,
>
> is increased by the first-mentioned person's omission to exercise a right, he shall be treated for the purposes of this section as having made a disposition at the time (or latest time) when he could have exercised the right, unless it is shown that the omission was not deliberate.

However the value of the estate of the account holder who withdraws the funds is not increased so the conditions of s.3(3) are not satisfied.

However, s.272 IHTA provides a wider definition of "disposition":

> "disposition" includes a disposition effected by associated operations;

It is considered that A makes a disposition (and hence a transfer of value) by associated operations at stage (2). Section 268(3) IHTA provides:

> Where a transfer of value is made by associated operations carried out at different times it shall be treated as made at the time of the last of them; but where any one or more of the earlier operations also constitute a transfer of value made by the same transferor, the value transferred by the earlier operations shall be treated as reducing the value transferred by all the operations taken together, except to the extent that the transfer constituted by the earlier operations but not that made by all the operations taken together is exempt under s.18 above.

"Associated operation" is defined in s.268(1) IHTA. This provides (so far as relevant):

> (1) In this Act "associated operations" means ... any two or more operations of any kind, being—
>
> (a) operations which affect the same property, or one of which affects some property and the other or others of which affect property which represents, whether directly or indirectly, that property, or income arising from that property, or any property representing accumulations of any such income, or
>
> (b) any two operations of which one is effected with reference to the other, or with a view to enabling the other to be effected or facilitating its being effected, and any further operation having a like relation to any of those two, and so on,
>
> whether those operations are effected by the same person or different persons, and whether or not they are simultaneous; and "operation" includes an omission.

The associated operations are:

(1) A's payment into the account.[28]
(2) B's withdrawal from the account.

HMRC agree. The IHT Manual provides:

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28 It might be argued that the associated operation is A's omission to withdraw from the account; it makes no difference if this is the case.

15043 - The extent of the claim (England, Wales and Northern Ireland): lifetime gifts arising out of a transfer of an account into joint names
[October 2007]
Where A places money in a joint account (IHTM15042) in the names of A and B as joint tenants (IHTM15082) and retains the right to withdraw the whole of it, as a general rule there will not be a lifetime transfer (IHTM15060) at the time the money is paid into the account. *But if any part is subsequently withdrawn for the benefit of B, the other joint owner, there may be a transfer at that time.*
Refer to TG any case where
- there is such a withdrawal
- it is claimed that there was an immediate gift when the money was paid into the joint account
- there is evidence that an immediate gift was intended, or
- the position is more complicated, for example where withdrawals need both signatures

(This text has been withheld because of exemptions in the Freedom of Information Act 2000)

53.8.8 *Spouse exemption on lifetime withdrawal by account holder*

The IHT spouse exemption may apply to the transfer of value on the lifetime withdrawal by an account holder. Since HMRC accept the application of the spouse exemption on death, they must also accept its application during the lifetime of the account holders.

The exemption does not of course apply one spouse is and the other is not UK domiciled because the IHT spouse exemption is restricted. The transfer of value takes place when the funds are withdrawn from the account so that is the point where the conditions for the spouse exemption need to be satisfied. For instance if:

(1) Year 1: H makes a payment into the joint account
(2) Year 2: W makes a payment from the joint account

The IHT exemption applies if the conditions for the exemption are satisfied in Year 2. It does not matter whether or not they are satisfied in Year 1.

53.8.9 *One account holder pays in and same account holder withdraws money*

Suppose:

(1) A transfers his money into the joint account held by A and B and
(2) A withdraws that money into his own name.

A does not make a transfer of value. What about B? His estate is reduced at stage (2). But it is considered that B makes no transfer of value. It might be said that B makes a transfer of value by associated operations, the operation being B's omission, but that would not be consistent with the policy of s.3(3) IHTA. This can be rationalised by saying that although B makes an omission, which is an associated operation, B does not make a transfer of value by associated operations.

53.8.10 *Third party pays into account*

The discussion above assumes that the account money is provided by one or both account holder.
Suppose:

(1) A third party transfers his money into a joint account held by A and B and
(2) A dies.

In strictness A is taxed on the whole account, but by concession it appears that he is taxed on half. The IHT Manual provides at 15042:

> You should modify this approach where this is necessary to give effect to the realities of the situation.
> *Example*
> A, B and C share a joint account. They all contribute to it. A dies and his proportion of the account accrues by survivorship to B and C. After A's death, the entitlement of B and C should take into account A's contributions.
> **(This text has been withheld because of exemptions in the Freedom of Information Act 2000)**

Presumably this means that after the death of A, B and C are each regarded entitled to (1) their own contributions to the account and (2) half of the contribution of A.

Suppose:

(1) A third party transfers his money into a joint account held by A and B and
(2) A withdraws that money into his own name.

It is suggested that B does not make a transfer of value. It might be said that there is a transfer of value by associated operations, the operation being the omission by the first account holder, but that would only be the case if the two steps formed part on an arrangement; any other view would not be consistent with the policy of s.3(3) IHTA.

53.8.11 *Payment out of account by way of gift*

If B draws on the account to make a gift to a third party donee, B has made a transfer of value.

If A had paid the account money into the joint account A has also made a transfer of value by associated operations at the time of B's withdrawal.[29] But that is not the case if B, or a third party, has provided the funds.

53.8.12 *Planning implications*

The best way to avoid the difficulties described in this section is that substantial sums should not be put in joint accounts at all (except where the account holders qualify for the full IHT spouse exemption). An alternative might be to use a joint account but to specify carefully the terms on which the account is held, but in practice it would be easier to use separate accounts. However in practice that joint accounts will frequently be used, and (as the frequent references in the manual to withheld text suggest) this is an area with many anomalies and therefore scope for tax planning.

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29 It is considered that there is no transfer of value under s.3(3) IHTA because although the estate of the third party donee is increased, it is not increased by any failure to exercise a right. But since there is a transfer of value by associated operations, this does not matter.

53.9 Scottish joint account

The IHT Manual provides:

15050. Special destinations and proof of donation
If two or more persons purchase an asset jointly there may be a contractual agreement between them which determines how the property devolves on death.

- If the title is just in their joint names, such as to A and B, they own an equal share which passes to their executors (IHTM05012) on their deaths and is part of their free estate.
- But if the title is to A and B and the survivor and they have paid equally for the asset, the survivor will be entitled to the whole on the death of the first to die (*Perrett's Trs v Perrett* [1909] 46 SLR 453). This is known as special (or survivorship) destination.

Both parties do, however, have the right to dispose of their shares in life (*Steele v Caldwell* [1979] SLT 228), which will defeat the operation of the special destination.
If the price was not provided equally, it is a question of the donor's intention whether he has conferred an immediate beneficial interest (IHTM15011) on the other party. Such a donor can revoke the survivorship destination, explicitly, by will (IHTM12040) under s.30 Succession (Scotland) Act 1964. But the donee may not do the same to defeat the donor's right to the whole of the asset.
If the whole of a joint asset was provided by one party he retains ownership of the whole till he delivers title, or, by intimation, indicates an intention to make an immediate gift to the other joint owner.

- Proof of gift requires both intention and delivery. 'Intention' does not require writing as proof and delivery may be actual or constructive, for example by intimation to the donee or his agent.
- If there is no immediate gift (by intention and delivery) the asset remains part of the provider's estate and will only pass to the other under the survivorship destination on his death, in the absence of any explicit testamentary revocation conforming to s 30 Succession (Scotland) Act 1964.

15051. Joint money accounts [October 2007]
The terms in which bank accounts and deposit receipts are held do not of themselves indicate the extent of common ownership (IHTM15093) nor do they imply the existence of a special destination (IHTM15054). The terms of a deposit receipt do not have a testamentary effect. The extent of each owner's interest will be a question of fact depending on

- the extent of their identifiable contributions, and
- if contributions are unequal whether there can successfully be established donation (IHTM15050) by the greater contributor to the other, or alternatively, whether the asset was held in joint names merely for administrative convenience

You should resist any suggestion by parties that the terms in which such monies are held can effect either a lifetime gift – or pass the property to a survivor, unless there is other supporting evidence. Any cases of difficulty should be referred to TG.

15052. Land [August 2006]

The title to heritage is proof of its ownership, and the owners interests in it – unless there is evidence to the contrary, normally by way of written document. If there is no special destination (IHTM15050) and there is equal provision of the price, each co-owner can dispose of his own share as part of his estate and there is no accretion among them.

If spouses or civil partners (IHTM11032) are the joint owners you should keep the 'related property' (IHTM09731) provisions in view (S.161 IHTA 1984).

If it is claimed the beneficial interests (IHTM15011) vary from those indicated by the title and the absence of gift is claimed, strong proof is required of parties intentions such as a contemporaneous writing. In cases of difficulty refer to TG (IHTM01081).

15053. Which law to apply to joint investments owned by someone domiciled in Scotland [October 2007]

Scottish law applies to shares of a company registered in Scotland. If the IHT 200 (IHT10021) or other account does not indicate whether a company is Scottish or not, ICES (IHT01023) will be able to provide this information. If the taxpayer is of Scots domicile (IHT13000) a joint holding in Government Stock may be regarded as subject to Scots law (*Cunningham's Trs v Cunningham* [1924] SLT 502).

15054. Joint money accounts and special destination [June 2006]

Under Scots Law where Bank or Building Society Accounts are held in joint names and the survivor the special (or survivorship) destination (IHTM15050) does not by itself pass the ownership of the money in the account to the survivor. An Account with a Bank or Building Society is not a document of title as it is not a Deed of Trust in terms of the Blank Bonds and Trusts Act 1696. Rather it is a contract between the Bank and the customer which regulates the conditions on which the Account is to be operated and is for administrative convenience only. See for example *Cairns v Davidson* 1913 SC 1054.

The result is therefore that the question of the ownership of the funds in the Account falls to be determined according to the ordinary principles of ownership. The owner of the funds deposited in the Account remains the owner unless and until some transfer of ownership has occurred.

Example

Where a Husband and Wife open an Account, governed by Scots law, in their joint names and the survivor and the Husband has provided the whole funds then on his death survived by his Wife:

- In the absence of some act of transfer of ownership to the Wife (e.g. a separate Deed of Gift) the whole Account should be included in the IHT 200
- If under the terms of the deceased's Will/Intestacy the Account passes to (say) the children then Inheritance Tax will prima facie be payable
- If under the terms of the Will/Intestacy the Account passes to the spouse or civil partner (IHTM11032) then exemption under S.18 IHTA 1984 will be appropriate

This applies to all Bank/Building Society Accounts governed by Scots Law. It will apply therefore to taxpayers living in England Wales and NI who have an Account which is governed by Scots Law.

I would appreciate the view of Scottish readers as to whether this is entirely correct. See too the discussion in the Trusts Discussion Forum May 2007 under the thread "Scottish bank accounts".

53.10 Associated operations on inter-spouse gift

The IHT Manual provides:

> **14833 - Associated operations: gifts between spouses or civil partner**
> [August 2006]
> Where property
> - given unconditionally by one spouse or civil partner to the other is
> - subsequently transferred by the latter to a third party,
>
> you cannot use the associated operations provisions to attribute the transfer to the first spouse or civil partner.
> The Chief Secretary to the Treasury assured Parliament that this would be HMRC's practice, and it was publicised in a Press Release dated 8 April 1975.

53.11 IHT planning for mixed marriage

53.11.1 *Simple gift to foreign domiciled spouse*

A simple and obvious short- and medium =-term course is:

(1) the UK domiciled spouse should give assets to his foreign domiciled spouse absolutely;
(2) the foreign domiciled spouse keeps the assets in a form where they are not UK situate, so they remain excluded property.

The gift may be a PET but that may not in practice be a serious concern. If the reservation of benefits rule applies, however, this effectively neutralises any tax saving. Indeed it may make the position worse. See 45.18 (IHT spouse exemption defence to GWR charge on death). This often makes simple gifts impractical.

53.11.2 *Gift to foreign domiciled spouse, followed by settlement by spouse*

A more sophisticated option is:

(1) the UK domiciled spouse gives assets to his foreign domiciled spouse; and
(2) the foreign domiciled spouse subsequently gives the assets to a settlement.

In principle the property in the settlement may be excluded property. One advantage of this is if the donee spouse later becomes UK domiciled: see 48.1 (IHT planning in anticipation of acquiring UK domicile). Another advantage is CGT planning. A third advantage is that this should avoid the gifts with reservation rule.[30] Of course this strategy only works if the UK domiciled spouse is not a settlor: see 58.34 (Planning to create trust with foreign domiciled settlor).

53.12 CGT spouse exemption

Section 58(1) TCGA provides:

> **Spouses and civil partners**
> If, in any year of assessment,
> (a) an individual is living with his spouse or civil partner, and
> (b) one of them disposes of an asset to the other,
> both shall be treated as if the asset was acquired from the one making the disposal for a consideration of such amount as would secure that on the disposal neither a gain nor a loss would accrue to the one making the disposal.

I refer to this as "**the CGT spouse exemption**". This exemption applies regardless of the domicile of the spouses. It applies to sales at market value as well as gifts.

The relief does not apply to (1) unmarried couples or (2) married couples living apart. Section 58(2) contains (usually) immaterial exceptions which are not discussed here.

30 See 45.13 (Gift to foreign domiciled donee who creates a settlement).

53.13 CGT planning for mixed marriage

53.13.1 *Asset yielding a gain*

Suppose the UK domiciled spouse owns an asset which will give rise to a gain on a disposal. A simple and obvious course is:

(1) The UK domiciled spouse transfers[31] the asset to his foreign domiciled spouse.
(2) The foreign domiciled spouse may be in a position to sell the asset without CGT: see 36.1 (CGT on individuals).

Watch *Furniss v Dawson*!

53.13.2 *Non-resident spouse*

The relief applies regardless of residence, so similar planning points arise if one spouse is UK resident and the other is not. CG Manual para 22304 accepted this:

> **Between husband and wife or between civil partners: Avoidance: NR spouse or NR civil partner: IT [March 2006]**
> There is no longer any authority to treat a non-resident spouse as separated from a resident spouse merely because of their residence status. Similarly a non-resident civil partner may not be treated as separated from a resident civil partner merely because of their residence status. So the possibility of passing assets outside the UK tax net remains.

This paragraph has been quietly deleted[32] but the law is unchanged.

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31 The transfer may be a gift or a sale at market value. The latter avoids the IHT problems discussed at 53.2 (Restriction on IHT spouse exemption for foreign domiciled spouse) and 45.8 (GWR spouse exemption) but take care on implementation, especially s.58(2) TCGA. In the case of a sale the spouse will need independent legal advice.

32 Probably in June 2008 when para 22300 was amended, or perhaps subsequently but by July 2009.

53.14 Income tax planning for mixed marriage

A simple and obvious course is:

(1) the UK domiciled spouse should give assets to his foreign domiciled spouse absolutely; and
(2) the foreign domiciled spouse invests in property giving rise to foreign investment income which is not remitted.

The inter-spouse gift, strictly, satisfies the transfer of asset conditions. The transferor would then fall within s.720 ITA since he has "power to enjoy" his wife's income. This is because s.714(4) ITA provides:

> (4) In this Chapter references to individuals include their spouses or civil partners.

However, RI 201 provides relief:[33]

> Unless transactions are part of a wider arrangement, Revenue practice is not to seek to assess a UK domiciled individual on the income of a non-UK domiciled spouse, where that income arises from a transfer of assets by that spouse and would be outside the charge to tax under s 739 ICTA by virtue of the provisions of s 743(3) ICTA.

The gift would also be a "settlement" for the purposes of s.624 ITTOIA. However, s.626 ITTOIA normally provides relief:

> **626 Exception for outright gifts between spouses or civil partners**
> (1) The rule in s.624(1) does not apply in respect of an outright gift—
> (a) of property from which income arises,
> (b) made by one spouse to the other or one civil partner to the other, and
> (c) meeting conditions A and B.
> (2) Condition A is that the gift carries a right to the whole of the income.
> (3) Condition B is that the property is not wholly or substantially a right to income.
> (4) A gift is not an outright gift for the purposes of this section if—

33 This is perhaps a concession but the better view is that the inter-spouse transfer is tax mitigation not tax avoidance so the motive defence applies. Tax Bulletin 81 states (obviously) that the same practice applies to civil partners.

(a) it is subject to conditions, or
(b) there are any circumstances in which the property, or any related property[34]—
  (i) is payable to the giver,
  (ii) is applicable for the benefit of the giver, or
  (iii) will, or may become, so payable or applicable.

34 s.626(5) ITTOIA provides that:

> "'Related property' has the same meaning in this section as in s.625."

So we turn to s.625(5) which provides:

> "In this section 'related property', in relation to any property, means income from that property or any other property directly or indirectly representing proceeds of, or of income from, that property or income from it."

CHAPTER FIFTY FOUR

THE FAMILY HOME AND ITS CHATTELS

54.1 Home owned by foreign domiciliary

There are many ways to arrange the ownership of a UK family home for a foreign domiciled individual. The first possibility is that the individual should own the property directly. This has the attraction of simplicity. Also, some UK banks are said to be unwilling to lend to offshore companies. This may also be necessary, or at least desirable, in order to secure that the owner of a long lease acquires the right to enfranchisement.

The main disadvantage is that the property is in the individual's estate and in principle within the scope of IHT on his death. One possible method to mitigate this problem is to provide by will that the property should pass to the individual's surviving spouse, or to a trust under which she has an interest in possession. That normally postpones IHT until the occasion of the death of the survivor of the individual and his spouse.[1]

The risk of IHT may quite simply be covered by insurance. Watch that the insurance policy is not subject to IHT on the death of the individual. Perhaps arrange that the policy is not UK situate[2] (so the policy is excluded property) or transfer the policy to a trust (under which the individual is excluded). The amount to be insured will need to be reviewed from time to time in line with house inflation and possible changes in the rate of IHT.

It should be possible to transfer the property to a company so as to acquire excluded property status, even at very short notice, if the death of the owner became imminent. There is a SDLT charge. So in practice the IHT risk is limited to the risk of the sudden death of the individual (or the sudden joint deaths of individual and spouse).

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1 See 45.18 (IHT spouse exemption defence to GWR death charge).

2 See 59.17 (Insurance policy).

There will be no CGT on the sale of property if main private residence relief applies. If the individual has another residence inside or outside the UK, it may be appropriate to make an election under s.222 TCGA.

There is in principle a taxable remittance, if the purchase price is paid out of foreign income or chargeable gains within the scope of the remittance basis.

Similar points apply to chattels in the home except there is no CGT exemption, apart from the exemption for chattels under £6,000: s.262 TCGA.

54.2 Home owned by estate IP trust

This avoids the need for an English grant of probate after the death of the individual.

The IHT position is broadly the same as absolute ownership by the foreign domiciled individual. This course is only practical, however, for estate IPs where:

(1) the life tenant is the settlor; or
(2) the settlor is dead; or
(3) the settlor has no interest in the settlement; or
(4) the settlor can be excluded from a sub-fund (which will hold the UK home); or
(5) the settlement was made before 18 March 1986.

Otherwise HMRC may argue that there is a charge on the death of the settlor under the GWR rules.[3]

The use of a non-resident trust involves a capital payment received in the UK, giving a s.87 charge if there are trust gains. Trust gains may arise on a disposal of the house, if the private residence exemption is not fully available, for instance if:

(1) the grounds exceed the "permitted area"; or
(2) there is another private residence which qualifies for the relief; or
(3) in relation to chattels which do not qualify for exemption.

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3 See 45.7 (Gift of excluded property).

54.3 Home owned by discretionary trust

In principle a discretionary trust or non-estate IP trust could hold the UK home between ten year anniversaries. This might be a convenient short or medium term way to hold a family home. This course is only practical, however, where:

(1) the settlor is dead; or
(2) the settlor has no interest in the settlement; or
(3) the settlor can be excluded from a sub-fund (which will hold the UK home); or
(4) the settlement was made before 18 March 1986.

Otherwise HMRC may argue that there is a charge on the death of the settlor under the GWR rules.[4]

54.4 Loan secured on property

It clearly makes IHT sense for any existing loans to be secured on the UK property. It is also possible to borrow in order to mitigate IHT.[5] Commercial borrowing is likely to be an expensive solution to the IHT problem but borrowing from a friendly trust may be practical.

54.5 Home owned by non-resident company

54.5.1 *IHT advantages and sham*

For inheritance tax, the obvious course is for the UK home of a foreign domiciliary to be owned beneficially by a foreign company. The shares in the company are not UK situate, and qualify as excluded property for IHT. The company would usually be held by an offshore trust.

An argument that an arrangement of this kind was a sham was rejected in *Skyparks v Marks* [2001] WTLR 607. But sham is a question of fact in each case. In some badly created structures the taxpayer may wish to argue that the company is a sham (or at least that it holds its assets as

4 See 45.7 (Gift of excluded property).
5 See 47.1 (IHT deduction for debts).

nominee) to avoid a benefit in kind charge.

54.5.2 *Ownership by non-resident company: CGT*

The company will not be subject to CGT or corporation tax on chargeable gains provided it is not resident.

If the company is owned by an individual, the gains will be treated as accruing to the individual under s.13 TCGA.[6]

If the company is held by a trust, the gains would be "trust gains".

54.6 Home owned by company: benefit in kind charge

The charge on living accommodation is to be found in ss.97 and 102 ITEPA:

> **97 Living accommodation to which this Chapter applies**
> (1) This Chapter applies to living accommodation provided for—
> (a) an employee, or
> (b) a member of an employee's family or household,
> by reason of the employment.
> ...
> **102 Benefit of living accommodation treated as earnings**
> (1) If living accommodation to which this Chapter applies is provided in any period—
> (a) which consists of the whole or part of a tax year, and
> (b) throughout which the employee holds the employment,
> the cash equivalent of the benefit of the accommodation is to be treated as earnings from the employment for that year.
> (2) In this Chapter that period is referred to as "the taxable period".

The EI Manual contains much interesting material on these provisions which cannot be set out here for lack of space.

54.7 "Employer", "employee" and "employment"

Section 5 ITEPA provides a relatively commonsense definition of these terms. It extends the concept of "employment" to include officers (e.g.

6 See 39.22 (Private residence relief).

directors who may not as a matter of employment law be employees):

> **Application to offices and office-holders**
> (1) The provisions of the employment income Parts that are expressed to apply to employments apply equally to offices, unless otherwise indicated.
> (2) In those provisions as they apply to an office—
> (a) references to being employed are to being the holder of the office;
> (b) "employee" means the office-holder;
> (c) "employer" means the person under whom the office-holder holds office.

54.8 "Family" and "household"

54.8.1 *"Family"*

Section 721(4) ITEPA defines "family":

> For the purposes of this Act the following are members of a person's family—
> (a) the person's spouse or civil partner,
> (b) the person's children and their spouses or civil partners,
> (c) the person's parents, and
> (d) the person's dependants.

Illegitimate children do not count as "children"; see s.721(6).[7] This is anomalous by contemporary standards but it will not often be relevant and the parent of illegitimate children is not likely to complain. Stepchildren are also excluded, as are parents-in-law. They will however still qualify as family if they are dependants.

54.8.2 *"Household"*

Section 721(5) ITEPA provides:

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7 In Scots law there are no illegitimate children so this does not apply to Scots domiciled individuals: s.21 Family Law (Scotland) Act 2006.

> For the purposes of this Act the following are members of a person's family or household—
> (a) members of the person's family,
> (b) the person's domestic staff, and
> (c) the person's guests.

54.9 "By reason of the employment"

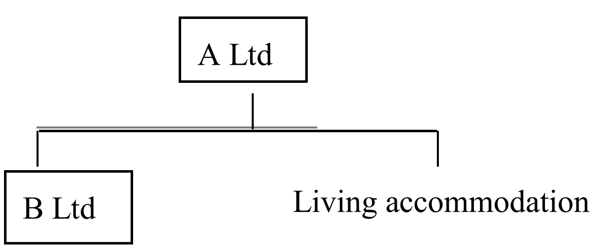
The expression "by reason of the employment" is extended by s.97(2) ITEPA so it does not mean "by reason of the employment" at all:

> Living accommodation provided for any of those persons by the employer is to be regarded as provided by reason of the employment ...[8]

Thus:

(1) Where the accommodation is provided by the employer, one does not ask whether it is actually provided by reason of employment: it is deemed to be so provided.
(2) Where accommodation is provided by another, the living accommodation charge only applies if the accommodation is actually provided by the employer.

Suppose a company A owns living accommodation (occupied by T) and holds the shares in B Ltd:



If T is an employee of A Ltd he is in principle taxable on the living

8 The subsection continues:
"unless—
(a) the employer is an individual, and
(b) the provision is made in the normal course of the employer's domestic, family or personal relationships."
The exception is not relevant here.

accommodation. The fact that the property is not provided by reason of the employment is irrelevant as the deeming provision in s.97(2) applies. If T is only an employee of B Ltd he is only taxed if he actually occupies the property by reason of his employment.

B Ltd is (by definition) a person involved in providing the accommodation[9] but B Ltd is not deemed to provide the accommodation.

54.10 Accommodation available but unused

EIM provides:

> **11405 Living accommodation: meaning of provided: the legislation**
> ...
> Provided is not defined in the legislation and its meaning has not been considered by the courts in relation to a charge under s.145 ICTA 1988. (s.145 has now become part of Part 3 Chapter 5 ITEPA 2003). The word provided must be given its ordinary dictionary meaning of supplied or furnished with a thing.
> In some cases provided will mean available for use whereas in others it will mean actually used (see EIM11406 for more detail). The meaning of provided is often an issue in the case of provided holiday living accommodation.
> **11406 Living accommodation: Meaning of provided: Practical considerations**
> For details of the relevance of the word "provided" in living accommodation cases see EIM11405.
> In deciding in a particular case whether provided means available for use, or means actually used, the following questions should be asked.
> - Who can use the living accommodation? We accept that if living accommodation is genuinely available for use by more people than could actually use it at any one time then provided only means the periods actually used. For example if five unrelated employees were allowed to use an employer owned two bedroom holiday villa we would only seek a provided living accommodation charge on each employee for the period in which that employee actually used the villa.
> - Why was the living accommodation bought or rented and how has it been used since acquisition? If the living accommodation was

9 See 54.14.1 (Person involved in providing the accommodation).

bought as holiday accommodation for a director and family, provided is likely to mean available for use. By contrast if it was bought as a genuine letting business by the employer and has been let out commercially then provided will only mean the periods of actual use by the employee.

For examples illustrating these points see example EIM11421 onwards.

EIM 11421 to 11423 provides three examples:

11421. Living accommodation: Meaning of provided: Example 1 [March 2007]

[Example 1 is as follows:]

A UK company purchases a flat in a French ski resort for £200,000. It is agreed that a market rental for the property would be £500 per week during the 6 month skiing season and £100 per week during the rest of the year. A husband and wife who are both directors of the company use the flat for holidays with their children for 3 weeks during the ski season and one week in the rest of the year. Their children are neither employees nor directors of the company. *The employer advises that the sole reason the property was bought was as a holiday home for the husband and wife. It has only been used by them as a holiday home.*

[Emphasis added to show how example 1 differs from the others]

We would argue in this case that provided is equivalent to available for use. Assuming that the flat was habitable for the whole of the year we would seek a benefit under Part 3 Chapter 5 measured on availability for the whole of the year. The employer may argue that the husband and wife work full time and that this prevents them using the flat for more than the 4 weeks in the year of actual use and so they are effectively only provided with it for 4 weeks. We do not accept that argument.

If the cost of the accommodation exceeds £75,000, then the amount of the cash equivalent would be calculated in accordance with s.106 ITEPA 2003 (see EIM11472). As the annual value is based on the open market rental, under ESC A91b the Inland Revenue restricts the cash equivalent of the benefit to step 1 of s.106. This would mean that the cash equivalent for the tax year would be £15,600 (£500 × 26 + £100 × 26). Under s.108 that would be split between the husband and wife in whatever way was just and reasonable, presumably half each in this case (see EIM11472).

11422. Living accommodation: Meaning of provided: Example 2 [March 2007]

[Example 2 is as follows:]

A UK company purchases a flat in a French ski resort for £200,000. It is agreed that a market rental for the property would be £500 per week during the 6 month skiing season and £100 per week during the rest of the year. A husband and wife who are both directors of the company use the flat for holidays with their children for 3 weeks during the ski season and one week in the rest of the year. Their children are neither employees nor directors of the company. *The company* *bought the property to let as a commercial letting business. They have employed professional agents to let the property and have managed to let the property for 12 weeks of the year in addition to the period it was used by the husband and wife directors.*

[Emphasis added to show how example 2 differs from the others]

In this case we would accept that provided is equivalent to actual use.

If the cost of the accommodation exceeds £75,000, then the amount of the cash equivalent would be calculated in accordance with s.106 ITEPA 2003 (see EIM11472). As the annual value is based on the open market rental, under ESC A91b the Inland Revenue restricts the cash equivalent of the benefit to step 1 of s.106. This would mean that the cash equivalent for the tax year would be £1,200 (£15,600 × 4/52). Under s.108 ITEPA 2003 that would be split between the husband and wife in whatever way was just and reasonable, presumably half each in this case (see EIM11472).

You may ask why the s.105 ITEPA 2003 charge is not £1,600 (being 3 weeks at £500 in the skiing season and 1 week at £100 outside the season). The answer is that the wording of s.105(3) requires us to look at a proportion of the annual rent rather than the rent for the actual weeks it was used.

11423. Living accommodation: Meaning of provided: Example 3 [March 2007]

[Example 3 is as follows:]

A UK company purchases a flat in a French ski resort for £200,000. It is agreed that a market rental for the property would be £500 per week during the 6 month skiing season and £100 per week during the rest of the year. A husband and wife who are both directors of the company use the flat for holidays with their children for 3 weeks during the ski season and one week in the rest of the year. Their children are neither employees nor directors of the company. *The employer says that the property was bought to let commercially and for the use of other employees of the company. In fact there have been no commercial lettings during the year and it has only been used for one week of the year by an employee of the company who was the director's secretary.*

[Emphasis added to show how example 3 differs from the others]

This is a case where in practice we would seek to test whether what the employer was telling us was correct. For example, what if any evidence is there of attempts to let the property commercially or to advise other employees of the company of its availability for use by them? Based on that evidence it is then a matter of judgement whether in reality the sole reason the property was bought was as a holiday home for the husband and wife directors, in which case the tax consequences would be as in example EIM11421. Or it may be that genuine attempts have been made to let the property commercially and make it available for use by other employees of the company, in which case the tax consequences in example EIM11422 will follow.

54.11 Shadow directors

The House of Lords decided in *R v Dimsey & Allen* 74 TC 263 that the benefit in kind provisions apply to shadow directors.[10] The reasoning continues to apply under ITEPA. The charge is unfair to a shadow director who does no work for the company. Income tax should be a tax on income. This is a tax on nothing. (The problem did not unduly concern the House of Lords because of the countering unfairness to HMRC of the case where the services of a shadow director were as valuable as a full-time employee. It appears that two equal wrongs made a right to tax.)

EI Manual 11413 states:

> **11413. Living accommodation: Avoidance area: Shadow directors**
> A person in accordance with whose directions or instructions the directors of a company are accustomed to act is deemed to be a director of that company by s.67(1) ITEPA. Where such a person (known as a shadow director) is provided with living accommodation by the company the individual will be within Part 3 Chapter 5 ITEPA in the same way as if the individual had held a formal appointment as a director. ...
> Many shadow directors are individuals who, although not domiciled in the UK, have come to work and reside here. In order to avoid a possible charge to inheritance tax, which could be imposed if such an individual died whilst working in the UK, an arrangement is made to set up an offshore company that owns the UK property in which the individual lives. Where the individual is a shadow director of that offshore company s.97(2) ITEPA deems the UK property to be provided to the shadow director by reason of the deemed employment.

In practice taxpayers (if they have considered the matter at all) generally seem to have taken the view on their facts that they are not shadow directors. HMRC have themselves had to identify the cases suitable for investigation. But in the author's experience even cases that HMRC have identified are not often pursued with much gusto. Perhaps (this is surmise) HMRC "officially" take the point to deter IHT planning, but at the same time don't bother much about it in practice because of the unfairness of the charge. If so, the tactic (while contrary to the rule of

10 This reversed an unreported Special Commissioners' decision that the provisions did not apply to shadow directors (or even properly appointed directors) unless they were actually employees. That decision remains relevant to penalty and negligence issues relating to periods before the decision in *Dimsey & Allen*.

law) works up to a point. Taxpayers cannot afford to plan on the assumption that HMRC's benign neglect of the provisions will apply to them.

54.12 Who is a shadow director?

Section 67(1) ITEPA provides:

> In the benefits code "director" ... includes any person in accordance with whose directions or instructions the directors of the company (as defined above) are accustomed to act.

Such a person is referred to as a "shadow director".[11]

In *Secretary of State for Trade and Industry v Deverell* Morritt LJ comments on this in numbered paragraphs:[12]

> (1) The definition of a shadow director is to be construed in the normal way to give effect to the parliamentary intention ascertainable from the mischief to be dealt with and the words used. In particular, as the purpose of the Act is the protection of the public and as the definition is used in other legislative contexts, it should not be strictly construed because it also has quasi-penal consequences in the context of the Company Directors Disqualification Act 1986.

This suggests that the comments in *Deverell* will apply in all contexts where the standard definition of "shadow director" is used, including tax contexts. It is difficult to argue that the "shadow director" concept should have a different meaning in a tax context than in the director disqualification context of *Deverell*. But *Deverell* is considering "shadow directorship" in the context of a commercial trading company. The position of a relatively quiescent property holding company is different.

> ... (2) The purpose of the legislation is to identify those, other than

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11 A note on terminology. This useful and now familiar label was first used in the Companies Act 1980. The wording of the concept behind the label goes back to the Companies (Particulars as to Directors) Act 1917.

12 [2001] Ch 340 at p.354. *cf.* Kerr LJ's comment on "quotable pontific paragraphs, preferably numbered" in his readable memoir *As Far as I Remember*, 2006 Hart Publishing, p.285.

> professional advisers, with real influence in the corporate affairs of the company.

This paraphrase does not take us very far because it only raises the question as to what is meant by "real[13] influence".

> But it is not necessary that such influence should be exercised over the whole field of its corporate activities. ...

This is uncontentious. The income tax charge could apply where a trust held a company holding both a home and investments, even though the "shadow director" did not give "instructions" relating to the investments but only to the home.

> (3) Whether any particular communication from the alleged shadow director, whether by words or conduct, is to be classified as a direction or instruction must be objectively ascertained by the court in the light of all the evidence.

Obviously.

> In that connection I do not accept that it is necessary to prove the understanding or expectation of either giver or receiver. In many, if not most, cases it will suffice to prove the communication and its consequence. Evidence of such understanding or expectation may be relevant but it cannot be conclusive.

This is extraordinary. "Directions or instructions" are a subset of "communications" and the feature that distinguishes them is that a person giving instructions expects them to be followed and the person receiving them understands this.

> Certainly the label attached by either or both parties then or thereafter cannot be more than a factor in considering whether the communication came within the statutory description of direction or instruction.

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13 The dangerous and beguiling word "real" is normally an indicator of vague if not sloppy legal analysis.

This at least is correct.[14]

> (4) Non-professional advice may come within that statutory description. The proviso excepting advice given in a professional capacity[15] appears to assume that advice generally is or may be included.

This is equally extraordinary, for the concept of "directions or instructions" is the antithesis of the concept of "advice". The distinguishing feature is that the former is mandatory and the other is not. Of course, one may slide into the other. For instance, if a solicitor advises a company that a particular act is required by law, that failure to act would be a criminal offence, and that if the company broke the law the solicitor would refuse to act, such advice may arguably be characterised as a direction or an instruction. Since the proviso excepting advice given in a professional capacity can be taken to refer only to this situation it does not shed any light on the general meaning of "shadow director". The inference from the proviso excepting advice is invalidly drawn.[16]

> Moreover the concepts of "direction" and "instruction" do not exclude the concept of "advice" for all three share the common feature of "guidance".

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14 For other examples of the "label" doctrine, see *Drafting Trusts and Will Trusts*, James Kessler QC, Sweet & Maxwell, 7th ed., para 18.3.

15 See s.67(2) ITEPA:

> "... a person is not to be regarded as a person in accordance with whose directions or instructions the directors of the company are accustomed to act merely because the directors act on advice given by that person in a professional capacity."

16 The Court of Appeal overlooked the explanation in *Gore-Browne on Companies* para 25.4.2:

> "The saving for professional advice might appear, at first sight, to support a wider interpretation of the definition, for the saving would be unnecessary unless a wider meaning were given to that definition. There are two possible explanations. The first, and probably correct, explanation is that the saving appears as a result of pressure from the relevant professions to ensure that no attempt can be made even to argue that their activities are, as such, within the scope of shadow director provisions in company legislation. The second is that it is intended to deal with the case where professional advice is obtained from a person who happens to be a member of the company and, as an 'insider', potentially a shadow director."

The less said about this line of reasoning the better.

> (5) It will, no doubt, be sufficient to show that in the face of "directions or instructions" from the alleged shadow director the properly appointed directors or some of them cast themselves in a subservient role or surrendered their respective discretions. But I do not consider that it is necessary to do so in all cases. Such a requirement would be to put a gloss on the statutory requirement that the board are "accustomed to act" "in accordance with" such directions or instructions. It appears to me that Judge Cooke, in looking for the additional ingredient of a subservient role or the surrender of discretion by the board, imposed a qualification beyond that justified by the statutory language.

If the statutory language were: "in accordance with whose *wishes* the directors were accustomed to act" this would be a fair comment. But the expression "directions or instructions" shows that the position must be one where the shadow director commands and the properly appointed directors obey.

The points made in the passage are wholly negative. That is, in determining the issue of "shadow directorship":

(1) The understanding or expectation of the parties is *not* conclusive.
(2) The label attached by the parties is *not* conclusive.
(3) The fact that the communication is "advice" is *not* conclusive (except in the case of professional advice).
(4) The fact that the properly appointed directors surrender their discretions or act in a "subservient" role is *not* essential.

This does not answer the question: how *does* one identify a shadow director? The mere fact that there is a stream of communications from the individual to the company, which is acted on by the company, is not conclusive. The author regularly sends "communications" to the internet bookshop Amazon, and Amazon act on those communications without fail. Yet the author is not a shadow director of Amazon. The author regularly sends directions (a cheque is a direction) to his bank and Barclays act on those directions without fail. Yet the author is not a shadow director of Barclays Bank. In the 4th edition of this work I therefore concluded:

> that one can expect some back-tracking, refinement or qualification from the Courts in cases they regard as more meritorious than that of Mr. Deverell.

This has now been confirmed by *Ultraframe v Fielding*:[17]

> 1267 ... In my judgment, where the alleged shadow director is also a creditor of the company, he is entitled to protect his own interests as creditor without necessarily becoming a shadow director.
> 1268 [Counsel] submitted that it is critical to distinguish the position of a lender (whether or not also a shareholder) from that of a director. A lender is entitled to keep a close eye on what is done with his money, and to impose conditions on his support for the company. This does not mean he is running the company or is emasculating the powers of the directors, even if (given their situation) the directors feel that they have little practical choice but to accede to his requests. Similarly with customers who may, because of their buying power, be able effectively to dictate conditions to their suppliers (or the other way around). In other words a position of influence (even a position of strong influence) is not necessarily a fiduciary position. To find otherwise would place a wholly unfair and unnatural burden on men of business. In broad terms, I accept this submission.

The approach which applies to a creditor of the company also applies to a beneficiary of a trust which holds the company: he is entitled to "protect his own interests … without necessarily becoming a shadow director … In other words a position of influence (even a position of strong influence) is not necessarily a fiduciary position [i.e. is not necessarily a shadow directorship]."

HMRC Inspectors sometimes argue that where someone resides in a property held by a company which is held by a trust of which that person is a beneficiary, it is (at least) highly likely that that person must be a shadow director.[18] This is unjustified for the reason set out in *Ultraframe*.

Suppose a person treats the property owned by the company as his own

17 [2005] EWHC 1638, [2007] WTLR 835.

18 Note that there is no support for this view in the HMRC Manuals. Employment Income Manual 11413 states correctly that *where* an individual residing in property is a shadow director, there is a benefit-in-kind charge. It conspicuously does *not* state that the mere fact of occupation makes a shadow directorship "highly likely".

and has no dealings with the directors: he just ignores them. They do nothing (except perhaps charge their fees). In such a case the company may be a sham (or nomineeship). Whether or not that is so, the individual is not a shadow director. He gives no instructions.

A non-resident person may be a "shadow director".

54.12.1 *When is an agent of a company a shadow director?*

HMRC accepted that the activities of an agent appointed by trustees to manage the day to day affairs of a trust are not normally relevant in determining the place of general administration (formerly relevant for the purposes of CGT trust residence).[19] It is suggested that a similar principle applies in the context of shadow directorship. An agency agreement under which the occupier of a property was responsible for routine maintenance matters on behalf of the company would not make the individual a "shadow director" as long as the decision to enter into contract was properly made by the directors and the directors properly supervise the work of the individual. This should not be difficult if the directors understand their duties are to all beneficiaries of the trust (not just to the settlor) and if the individual occupier of the property also understands this. It would be different if the agency agreement covered matters not usually delegated by an investment company to an agent.

54.12.2 *Arranging that an occupier is not a shadow director*

Suppose an existing company purchases a home on the open market for a UK resident foreign domiciliary. The choice of a home is a personal one and the individual would normally have to give a "communication" to the company which HMRC may regard as "directions or instructions". So it would normally be difficult to ensure that the individual was not a shadow director (at least applying *Deverell* at face value). The position is different if:

(1) trustees purchase property directly, and
(2) the trustees transfer the property to a foreign company on their own initiative and without reference to the occupier.

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19 See the 5th edition of this book, para 5.6.2.

The trustees may reason that if the life tenant dies, the UK property would not be excluded property and a charge to inheritance tax would arise – the liability for which would fall on the trust fund. In discharge of their fiduciary duty they could transfer the property to a foreign company to create excluded property and protect the trust from the liability. The point is that the occupier has *not* instructed or even requested the company to purchase the property for him.[20] SDLT makes this expensive but the variant idea of assigning a contract entered into by the trustees may be considered practical.

It would be best if the directors and trustees were separate persons. All communications should be through the trustees and not the directors of the company. If the foreign domiciliary desires to sell and, perhaps, purchase another property, he should communicate his wishes to the trustees. Then:

(1) The trustees could put the company into liquidation. The liquidator would sell the property.
(2) Alternatively, the trustees may prefer to sell the company. That has stamp duty advantages, and would be attractive for a purchaser who is a foreign domiciled individual or non-resident trust.

The procedure may then be repeated for a new purchase. In these circumstances it would continue to be difficult for HMRC even to argue that the occupier was a shadow director.

54.13 The cash equivalent: ss.105 and 106 computations

The charge is on the "cash equivalent". Section 103 ITEPA provides:

> **Method of calculating cash equivalent**
> (1) The cash equivalent is calculated—
> (a) under s.105 if the cost of providing the living accommodation does not exceed £75,000; and
> (b) under s.106 if the cost of providing the living accommodation exceeds £75,000.

Thus there are two methods of calculating the cash equivalent, here called a s.105 computation and a s.106 computation. This is for historical

20 I am grateful to Peter Vaines for this suggestion.

reasons, the s.106 computation having been introduced by the FA 1983 to supplement the ancestor of s.105. This structure makes the law twice as complicated as it need be.

54.14 Cost of providing accommodation

One needs to know the "cost of providing living accommodation":

(1) in order to decide between the s.105 and s.106 computation;
(2) in order to make the s.106 computation (if applicable, as it usually is).

This expression is defined in s.104:

> **General[21] rule for calculating cost of providing accommodation**
> For any tax year the cost of providing living accommodation is given by the formula A + I – P

In short, *A* is **A**cquisition cost, *I* is **I**mprovement cost, and *P* is **P**ayment of reimbursement. In full detail:

> *A* is any expenditure incurred in acquiring the estate or interest in the property held by a person involved in providing the accommodation,
> *I* is any expenditure incurred on improvements to the property which has been incurred before the tax year in question by a person involved in providing the accommodation, and
> *P* is so much of any payment or payments made by the employee to a person involved in providing the accommodation as represents—
> (a) reimbursement of A or I, or
> (b) consideration for the grant to the employee of a tenancy or sub-tenancy of the property.

I consider reimbursement further in para 54.21 (Property purchase financed by the foreign domiciliary).

54.14.1 *Person involved in providing the accommodation*

Section 122 ITEPA provides the wide definition:

21 For the exception see 54.17 (Revaluation of cost in cases of delayed occupation).

> For the purposes of this Chapter "person involved in providing the accommodation" means any of the following—
> (a) the person providing the accommodation;
> (b) the employee's employer (if not within para (a));
> (c) any person, other than the employee, who is connected[22] with a person within para (a) or (b).

This defined phrase is only used in the definition of "cost of providing living accommodation".[23] ITEPA EN explains:

> 412. This definition makes it clear that it is necessary to look beyond the employer and the apparent owner of an interest in the accommodation. This is anti-avoidance legislation to counter schemes which depress the cost to the employer by using intermediate owners of interests.

54.15 Accommodation costing £75,000 or less: section 105 computation

Section 105 applies where the cost of providing accommodation does not exceed £75,000. This was a meaningful figure when the legislation was introduced in 1983 but inflation, the Chancellor's friend, has whittled away the real value of this limit so it must be exceptional now to find a purchase of less than £75,000. One might think the s.105 computation was a dead letter and one can turn directly to s.106. But s.106 refers back to s.105 so one needs to make the s.105 computation even in a s.106 case.
Section 105 ITEPA provides:

> **Cash equivalent: cost of accommodation not over £75,000**
> (1) The cash equivalent is to be calculated under this section if the cost of providing the living accommodation does not exceed £75,000.
> (2) The cash equivalent is the difference between—
> (a) the rental value of the accommodation for the taxable period, and
> (b) any sum made good by the employee to the person at whose cost the accommodation is provided that is properly

22 Section 718 ITEPA provides:
"Section 993 of ITA 2007 (how to tell whether persons are connected) applies for the purposes of this Act."

23 See 54.14 (Cost of providing accommodation) and 54.17 (Revaluation in cases of delayed occupation).

attributable to its provision.

The key concepts are "rental value of the accommodation" and "making good" and I deal with these in turn.

54.15.1 "*Rental value of the accommodation*"

As from 22 April 2009, s.105 ITEPA provides:

> (3) The "rental value of the accommodation" for the taxable period is (subject to subsections (4) and (4A) the rent which would have been payable for that period if the property had been let to the employee at an annual rent equal to the annual value.
> (4) Subsection (4A) applies where—
> (a) a rental amount is payable by the person ("P") at whose cost the accommodation is provided in respect of the whole or part of the taxable period ("the relevant period"), and
> (b) the amount so payable is payable at an annual rate greater than the annual value.
> (4A) Where this subsection applies—
> (a) subsection (3) does not apply to the relevant period, and
> (b) instead the "rental value of the accommodation" for the relevant period is the rental amount payable by P in respect of the relevant period.
> (4B) A reference in subsection (4) or (4A) to a rental amount payable by P in respect of the relevant period is to the sum of—
> (a) any rent for the period payable by P, and
> (b) any amount attributed to the period in respect of a lease premium (see sections 105A and 105B)
> (5) If the rental value of the accommodation for the taxable period does not exceed any sum made good by the employee as mentioned in subsection (2)(b), the cash equivalent is nil.

The key expression is "annual value". This is defined in s.110 ITEPA but it is not usually necessary to refer to that for UK property. ITEPA Explanatory Note states:

> 404. [Section 110] does not affect the Inland Revenue practice of using the gross rateable value as a proxy for "annual value". That practice will continue. The main use of this section is to provide guidance on how to arrive at the annual value of properties for which rent is not paid and in practice is only needed in cases where no gross

> rateable value can be found.[24]

The EI Manual provides at para 11434:

> The amount of annual value for UK properties is set out in the table below.

Country	When first valued	Annual value to take
England & Wales	All cases	The 1973 gross rating value
Northern Ireland	All cases	The 1976 gross rating value
Scotland		100/270 × the 1985 gross rating value
Anywhere in the UK	No gross rating value set	Ask the appropriate District Valuer to confirm any estimated figure provided by the employer that you want to check.[25]

> For the formula to convert a net rating value figure to a gross rating value figure see EI Manual 11438.

Thus for most purposes the s.105 computation is rateable value less sums "made good" to the employer. That is usually a trivial amount which has no relation to the value of the benefit of the living accommodation. It is a substantial amount in two cases:

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24 Likewise the EN at Change 23:
"These provisions [ss.110 and 207 ITEPA] will clarify how to find annual values in respect of those properties for which the practice of using gross rateable values or a proxy for them is inapplicable – for example overseas properties. In the case of both these and other properties, all the current practices used in quantifying the cash equivalent of the benefit of living accommodation will continue."

25 The Manual continues:
"If no such estimate is provided or the estimate is not acceptable the District Valuer will provide a (not negotiated) figure. If the taxpayer does not accept that figure the District Valuer will try to agree a figure with the taxpayer. For the procedure for referring to the District Valuer see EI Manual 11437."

(1) where the company "employer" pays a market rent for the property;
(2) where the property is not UK situate (and so there is no rateable value).

This practice (which is concession not law) exists for historical reasons. It is not surprising the Tax Law Rewrite did not think it appropriate to express all this in ITEPA. The rules are incoherent.

54.15.2 *"Making good": meaning*

The EI Manual provides:

> **21120. The benefits code: What is meant by "making good"** [June 2006]
> "Making good" simply means giving something in return for the benefit. What is being made good is the expense incurred by the employer or other person providing the benefit. It follows that in order to make good that expense the employee will give money, or something that can be measured in money. Usually the employee will "make good":
> - by a direct payment or
> - by deduction from salary or
> - by a suitable debit to the employee's current account in the employer's books and records.
>
> Any of these methods is acceptable.
> The giving of services by the employee, or anything that is not measured in money terms is not "making good", see *Stones v Hall* (60 TC 737).
> **(This text has been withheld because of exemptions in the Freedom of Information Act 2000)**[26]
> As regards "making good" by waiver of remuneration see EI Manual 21122.

It is clearly "making good" if:

(1) the company pays the costs of maintenance and insurance; and

26 [Author's Note] The "text withheld" announcement was added in June 2006. Previously the Manual stated "In any case where the taxpayer agues that an interest-free loan has been made to this employer specifically to make good the cost or value of a benefit, make a submission to Personal Tax (Technical), Solihull." That instruction probably survives in the now withheld text.

(2) the individual reimburses the company by a cash payment.

Does the employee make good the cost if he pays the cost of maintenance and insurance directly? Section 110 ITEPA envisages that this expenditure will be paid by the employer. In addition, the maintenance of the building is probably not a "sum" made good. EIM Manual is equivocal:

> **11439. Living accommodation: annual value of UK property: Employee responsible for repairs or insurance.** [June 2006]
> ...
> An employee may be responsible for the cost of repairs or insurance under the terms of his or her lease or employment. *(This text has been withheld because of exemptions in the Freedom of Information Act 2000.)*[27] As regards the discharge of the employee's pecuniary liability in respect of such items *see* EIM00520.

Note that the payment of a sum "making good" may constitute taxable property income of the company which receives it. The IHT and CGT implications may also need to be considered, but the sums involved are not usually significant.

54.15.3 *Making good: timing*

EIM provides:

> **21121. The benefits code: When must making good take place?**
> The legislation does not set a time limit on the "making good". This will usually happen shortly after the expense is incurred by the person providing the benefit. But you need not object to a belated "making good" if it is done within a reasonable time of the employee becoming aware that the chargeable benefit can be reduced, in whole or in part, by reimbursing the expense incurred by the provider.

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27 The text formerly read:

> "If an employee claims an adjustment to the annual value (derived from the table in EI Manual 11434) because the facts of an employee's case are not those envisaged by s.110 ITEPA, make a full report to Personal Tax (Technical), Solihull."

It seems a safe bet that that passage survives in the withheld text.

What constitutes a "reasonable time" will depend on the facts of the case. Do not allow a deduction for "making good" which takes place after a charge to tax on the benefit concerned has become final and conclusive.

54.16 Accommodation over £75,000: section 106 computation

Section 106 ITEPA provides:

> **Cash equivalent: cost of accommodation over £75,000**
> (1) The cash equivalent is calculated under this section if the cost of providing the living accommodation exceeds £75,000.
> (2) To calculate the cash equivalent—
> *Step 1* Calculate the amount that would be the cash equivalent if s.105 applied (cash equivalent: cost of accommodation not over £75,000).

See para 54.15 (Accommodation costing £75,000 or less: s.105 computation).

> *Step 2* Calculate the following amount ("the additional yearly rent")—
> ORI × (C – £75,000)

In short, *ORI* is **O**fficial **R**ate of **I**nterest; *C* is **C**ost. In full detail:

> where—
> ORI is the official rate of interest in force for the purposes of Chapter 7 of this Part (taxable benefits: loans) on 6 April in the tax year, and
> C is the cost of providing the accommodation calculated—
> (a) in accordance with s.104 (general rule for calculating cost of accommodation),[28] or
> (b) in a case where s.107 applies (special rule for calculating cost of providing accommodation), in accordance with that section instead.[29]

The label "additional yearly rent" is misleading: the "additional yearly

28 See 54.14 (Cost of providing accommodation).
29 See 54.17 (Revaluation in cases of delayed occupation).

rent" calculated in this way will not bear a close relationship with any actual market rent.

> *Step 3* Calculate the rent which would have been payable for the taxable period if the property had been let to the employee at the additional yearly rent calculated under step 2.

This step reduces the "additional *yearly* rent" to that for the "taxable period" (defined in s.102(2)).

> *Step 4* Calculate the cash equivalent by—
> (a) adding together the amounts calculated under steps 1 and 3, and
> (b) (if allowed by subsection (3)) subtracting from that total the excess rent paid by the employee.
>
> (3) In step 4—
> (a) para (b) only applies if, in respect of the taxable period, the rent paid by the employee in respect of the accommodation to the person providing it exceeds the rental value of the accommodation for that period as set out in s.105(3) or (4)(b), as applicable, and
> (b) "the excess rent" means the total amount of that excess.

In short, the charge is (1) the s.105 computation (rateable value) and (2) (official rate of interest on purchase price less £75,000) less rent.

This works (more or less) where the s.105 computation is based on the nominal amount of rateable value. It gives double taxation where the s.105 computation is based on actual market rental value. ESC A91 gives relief here:

> *Living accommodation provided by reason of employment*
> This concession applies to living accommodation treated as earnings under ITEPA 2003 Part 3, Chapter 5. Where ITEPA 2003 s.106 applies and the cash equivalent of the benefit of the accommodation is calculated by reference to the annual rent the property might fetch on the open market, the Inland Revenue will disregard "the additional yearly rent". If "the additional yearly rent" is disregarded then the

amount of "the excess rent" is deemed to be nil.[30]

54.17 Revaluation of cost in cases of delayed occupation

Normally the s.106 computation is based on the employer's acquisition cost (i.e. historic cost). Market value of the property later is not relevant. This rule could favour the taxpayer or HMRC, but as time passes it is likely to favour the taxpayer. In one case only there is an adjustment to market value. Section 107 ITEPA provides:

> **Special rule for calculating cost of providing accommodation**
> (1) This section contains a special rule for calculating the cost of providing living accommodation which—
> (a) operates for the purposes of step 2 of s.106(2) (calculating the additional yearly rent), and
> (b) accordingly only operates where the cost of provision for the purposes of s.106(1) (as calculated under s.104) exceeds £75,000.

In practice condition (b) will almost always be satisfied (except perhaps for property purchased many years ago).

> (2) This section applies if, throughout the period of 6 years ending with the date when the employee first occupied the accommodation ("the initial date"), an estate or interest in the property was held by a person involved in providing the accommodation.
> It does not matter whether it was the same estate, interest or person throughout.

In short, this condition is that the property has been owned by the company for six years before the employee moves in.

> (3) For any tax year the cost of providing the living accommodation for the purposes mentioned in subsection (1)(a) is given by the formula—
> $$MV + I - P$$

30 I do not understand the point of the last sentence, for if the additional yearly rent is disregarded, the "excess rent" is irrelevant.

In short, *MV* is **M**arket **V**alue; *I* is **I**mprovement cost; *P* is **P**ayments in return. In full detail:

> MV is the price which the property might reasonably be expected to have fetched on a sale in the open market with vacant possession as at the initial date,
> I is any expenditure incurred on improvements to the property which has been incurred during the period—
> (a) beginning with the initial date, and
> (b) ending with the day before the beginning of the tax year, by a person involved in providing the accommodation, and
> P is so much of any payment or payments made by the employee to a person involved in providing the accommodation as represents—
> (a) reimbursement (up to an amount not exceeding MV) of any expenditure incurred in acquiring the estate or interest in the property held on the initial date,
> (b) reimbursement of I, or
> (c) consideration for the grant to the employee of a tenancy or sub-tenancy of the property.

This may arise where:

(1) a foreign domiciliary (or trust) purchases a company holding a property acquired more than six years previously;
(2) an individual then occupies the property and becomes a shadow director.

Next is an anti-avoidance provision to block an obvious scheme to devalue MV:

> (4) In estimating MV no reduction is to be made for an option in respect of the property held by—
> (a) the employee,
> (b) a person connected with the employee, or
> (c) a person involved in providing the accommodation.

Lastly, for completeness, there is transitional relief where the employee first occupied the property before 31 March 1983: para 21 Sch.7 ITEPA.

54.18 Accommodation provided for more than one employee

Section 108 ITEPA provides:

Cash equivalent: accommodation provided for more than one employee

(1) If, for the whole or part of a tax year, the same living accommodation is provided for more than one employee at the same time, the total of the cash equivalents for all of the employees is to be limited to the amount that would be the cash equivalent if the accommodation was provided for one employee.

(2) The cash equivalent for each of the employees is to be such part of that amount as is just and reasonable.

EIM provides at 11411:

11411 - Living accommodation: provided to more than one employee in the same period: practical points

The following is an example of how s.108 ITEPA 2003 works.

An employer provides a ten room house for the shared use of three unrelated employees. Each employee has sole use of a bedroom and shared use of the other seven rooms. Without s.108 the cash equivalent of the benefit of the living accommodation provided to each employee would be 80% of the whole house. However s.108 limits the sum of the charges on the three of them to one full charge on the whole house. If there are no special factors each employee will be chargeable on the cash equivalent of a benefit of 33.3% of the cash equivalent for the whole house.

Section 108 is not relevant in some family situations. For example a husband and wife both work for the same employer and live together in a house provided by their employer. The husband's job is the one that has accommodation provided with it and the wife's does not. The true construction here is that the living accommodation is only provided by the employer to the husband and the wife lives in it with her husband as part of normal domestic arrangements. So the full living accommodation charge would be on the husband with no charge on the wife.

By contrast for an example of s.108 being relevant in a family situation see example EIM11421.

54.19 Ways to avoid benefit in kind

Ways to avoid the entire benefit in kind charge are (in short):

(1) to ensure that the occupier is
 (a) not an officer (i.e. not a director or company secretary, which is straightforward);
 (b) not an employee (which should be straightforward); and
 (c) not a "shadow director"; or
(2) not to use a company; or
(3) to reimburse the company for its expenditure.

54.20 Reimbursement as solution to IT charge

Reimbursement of "A" and "I" will solve the s.106 charge if it reduces the "cost of providing the accommodation" to nil (or at least to below £75,000). It does not avoid the s.105 charge (but that may be trivial or avoided by "making good" or arranging that the individual is not a shadow director).

54.20.1 *Who makes the reimbursement?*

Reimbursement is only deductible if it is made by the employee. For example, if

(1) a company purchases property;
(2) an individual (F) reimburses the cost;
(3) another individual (G) comes to occupy the property (and is a shadow director);

then F's reimbursement will not reduce the s.106 computation for G. Again, if a member of the family or household of the shadow director occupies the property, and that member of the family or household reimburses the company, that reimbursement will not reduce the s.106 computation for the shadow director. In practice this is not likely to happen often.

The IHT and CGT implications of making the reimbursement need to be considered.

54.21 Property purchase financed by the foreign domiciliary

Sometimes a company structure is set up specifically for the purpose of purchasing the home. That is, there is an arrangement under which:

(1) The individual agrees in principle to purchase a property.
(2) The individual:
  (a) lends the purchase price to a company, or
  (b) transfers the purchase price to a trust which lends the purchase price to a wholly owned company.
(3) The company makes the purchase.

This section considers whether an arrangement of this kind offers a defence to the benefit in kind charge.

54.21.1 *"Making good" and s.105 computation*

The s.105 computation allows a deduction for:

> any sum made good by the employee to the person at whose cost the accommodation is provided that is properly attributable to its provision.

The taxpayer would have to show that the interest forgone on the interest-free loan from the individual (directly or indirectly to the company):

(1) is a "sum", and
(2) "makes good" the provision of the accommodation.[31]

Whether the interest forgone "makes good" the provision of accommodation is a question of fact. Assuming the reason the interest is forgone is to enable the company to provide the accommodation, this condition should be satisfied.

Whether the interest forgone is a "sum" is a question of law; it is suggested that the word should not be construed strictly or technically, and an amount of interest forgone may be a "sum". See 54.15.2 ("Making

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31 It is assumed that the interest forgone exceeds the annual or rateable value of the accommodation, which will normally be the case.

good": meaning).

54.21.2 *Loan to company as defence to section 106 computation*

Sums "made good" are not deductible as such in the s.106 computation. Rent is deductible in a s.106 computation but the interest forgone on an interest-free loan is not rent. No-one suggests that the company would be taxable on the interest forgone as property income!

It has been suggested that a company financed by an interest-free loan has not incurred expenditure. If this is so then it is a complete answer to the s.106 charge because the figure *A* in the formula for the cost of providing accommodation is reduced to zero. The suggestion is raised in Stephen Brandon QC's *Taxation of Non-UK Resident Companies and their Shareholders*, Key Haven Publications, paras 5.3.3.8 to 5.3.3.15 citing *Wicks v Firth* [1983] STC 25 at 31:

> The scholarships were provided at the cost of ICI and not at the cost of the Trustees because the Trustees with moneys supplied by ICI were only performing fiduciary duties …

However (as Stephen Brandon QC recognises), it is a step from this to argue that a company which is not performing fiduciary duties does not incur expenditure. If the house is in the accounts of the company as an asset, how could it have acquired that asset without "incurring expenditure"? Suppose the boot were on the other foot: a company lent money interest-free to a shadow director to finance his own purchase. Would anyone accept that the company had provided the accommodation purchased by the individual? This is an argument to take *in extremis*.

54.21.3 *Reimbursement by the individual*

In computing the "cost" of providing the accommodation one may deduct payments representing reimbursement. This deduction would reduce the s.106 computation.[32] However, the interest forgone on the loan is not "reimbursement". In addition, it is also not a "payment".

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32 See 54.20 (Reimbursement as solution to IT charge).

54.21.4 *Release of loan*

A possible solution would be for the individual to release the debt which is due to him from the company.

Statute requires a "payment" representing a reimbursement. It is a moot point whether the release of the debt would be a "payment". One should take the cautious view that it may not be. The matter should be dealt with as follows:

(1) The individual transfers the funds to the company. They should be received in the company's bank account. This should be accompanied by a letter to the company saying: "I have today procured the payment of £X to your account. This is reimbursement for the expenditure you have incurred in acquiring [the property]. However, I require repayment of the debt due to me of £X."
(2) The company may then use its funds to repay its debt due to the individual.

Although this is a circular transaction (the payment being matched by immediate repayment) that does not nullify it for tax purposes: compare *MacNiven v Westmoreland* [2001] STC 237.

If the company incurs additional improvement expenditure in the future, this should be matched by further reimbursements so the total cost of providing the living accommodation (A+I–P) remains less than £75,000.

The reimbursement of the company is not a transfer of value for IHT purposes if the individual is (or is treated as) the beneficial owner of the company. For the same reason the reimbursement is not a disposal by way of gift and so is outside the scope of s.102 FA 1986 (gifts with reservation).

The effect of the gift (the reimbursement) is to increase the value of the shares of the company without any corresponding rise in the CGT base cost. So the gift increases the chargeable gain on the disposal. This should not matter so long as the law remains in its current form.

54.21.5 *Reimbursement: timing*

When must reimbursement be made? It is considered that the time limit is the same as for "making good". Reimbursement must be done within a reasonable time of the taxpayer becoming aware that the benefit in kind charge can be reduced by reimbursement.[33] In practice HMRC accept this.

54.22 Co-ownership defence to living accommodation charge

This section considers the position where an individual owns a share in the property jointly with the company.

Co-ownership raises similar but not identical issues for all provisions which charge tax on benefits, such as s.87 TCGA, s.731 ITA, s.203 ITEPA, and IHT gift with reservation rules as well as the living accommodation charge. The discussion here is limited to the case where an individual and a company are co-owners. Similar but not identical issues arise with these provisions where an individual and a trust are co-owners.

54.22.1 *The land law position*[34]

The starting point is to ascertain the rights of the co-owners as a matter of land law. Co-owned land in England and Wales is always held on trust. The person(s) holding legal title to the land are here called "the trust of land trustees".[35] The position is governed by the Trusts of Land and Appointment of Trustees Act 1996.[36] Section 12(1) TLATA provides:

> A beneficiary who is beneficially entitled to an interest in possession in land subject to a trust of land is entitled by reason of his interest to occupy the land at any time if at that time—
>
> (a) the purposes of the trust include making the land available for his

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33 See 54.15.3 (Making good: timing)

34 I am grateful to Charles Harpum for his assistance on this section.

35 (The term used in the legislation is "the trustees of land".) The company may be the (or one of the) trust of land trustees; it makes little practical difference and no difference at all for tax. (If the company is not a trustee it can apply to court to require the trustees to exercise their powers.) The shares in the company may also be held on trust but that trust is not relevant here.

36 Further consideration is needed for:
(1) Land outside England and Wales.
(2) Jointly owned chattels.
(3) Periods before 1 January 1997, when the TLATA took effect, but that will not now normally be relevant.
I would be grateful to any reader who could inform me of the position in Scotland.

occupation (or for the occupation of beneficiaries of a class of which he is a member or of beneficiaries in general), or
(b) the land is held by the trustees so as to be so available.

Prior to 1997, a co-owner of land had a right to occupy that land, in the absence of any contrary indication or agreement with the other co-owners:

> It has been well established law ... that a tenant-in-common under a trust for sale has the right to occupy the whole property without payment of rent ...[37]

This co-ownership right has been superseded and replaced by s.12 TLATA. In *IRC v Eversden*, Lightman J explained:

> On and after 1 January 1997 when the TLATA came into force, a tenant in common in equity ... was no longer automatically entitled ... to occupation of the property purchased. Section 12 of the TLATA provided that he should only become so entitled if one of two alternative conditions were satisfied…[38]

He then set out s.12(1).

While arguments might be advanced to the contrary this analysis should be followed, because it is a clear and workable rule. Otherwise it would be necessary to consider the pre-1997 law and try to work out the combined effect of that when read with s.12.[39]

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37 *IRC v Lloyds Private Banking* [1998] STC 559 at p.561; likewise *City of London Building Society v Flegg* [1988] AC 54 at 81.

38 [2002] STC 1109 at [24] reported 75 TC 340 under the name *IRC v Greenstock's Executors*.

39 Barnsley "Co-owner rights to occupy land" [1998] CLJ 123 is a minority view; contrast *Plural Ownership* (Roger Smith, OUP 2005) p. 136.
This conclusion is not affected by *Re Byford* [2003] EWHC 1267; [2004] 1 P&CR 159. In this case the co-owners were a wife and her former husband's trustee in bankruptcy. The issue was the relative size of their shares. The wife claimed a larger share because she had paid the mortgage since her husband's bankruptcy. The issue is not covered by any provision in TLATA. So the common law principles (known as "equitable accounting") applied. The general principle of equitable accounting is that one co-owner cannot take the benefit of an increase in the value of the property without making an allowance for what has been expended by the other in order to obtain it. Thus the wife had credit for her payments of mortgage capital and improvement expenditure. She wanted credit for interest

In the following discussion, the entitlement to occupy land conferred by s.12(1) is called the "statutory occupation right".

The individual will obviously have a statutory occupation right to occupy the property under s.12 because:

(1) He is a beneficiary under the trust of land.
(2) He is beneficially entitled to an interest in possession in the land.
(3) Both conditions (a) and (b) of s.12(1) are satisfied:[40]
    (a) the purposes of the trust of land include making the land available for his occupation; and
    (b) the land is held by the trust for land trustees so as to be available for the purpose.

The company does not have a statutory occupation right. It does not meet the conditions of s.12(1). No third person would have a statutory occupation right even if the company sold or sub-let their interest under the trust of land to that person. The third person would not satisfy conditions (a) or (b) of s.12(1).[41]

The trust of land trustees have various powers, but they do not have power to override the individual's occupation right or to require him to pay an occupation rent. This is fundamental so I set out the provisions in detail.

Section 13(1) TLATA provides:

> Where two or more beneficiaries are (or apart from this subsection would be) entitled under s.12 to occupy land, the trustees of land [i.e. the trust of land trustees] may exclude or restrict the entitlement of any one or more (but not all) of them.

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payments, but it was held that she must set against that credit the benefit of occupation (the wife had occupied the property and the trustee in bankruptcy of course had not occupied). There is nothing in this which affects rights of occupation or other rights under ss.12, 13 TLATA; though note Helen Conway's criticism in *The Conveyancer* [2003] 533.

40 Though it would suffice if only one of the conditions of s.12(1) were satisfied. Section 12(2) provides: "Subsection (1) does not confer on a beneficiary a right to occupy land if it is either unavailable or unsuitable for occupation by him." This will not apply here.

41 Also s.12(2) TLATA would probably apply, though it is not necessary to rely on that.

The trust of land trustees cannot under s.13(1) override the individual's statutory occupation right because it is not the case that "two or more beneficiaries are … entitled under s.12 to occupy land".

Section 13(6) TLATA provides:

> Where the entitlement of any beneficiary to occupy land under s.12 has been excluded or restricted, the conditions which may be imposed on any other beneficiary under subsection (3) include, in particular, conditions requiring him to—
> (a) make payments by way of compensation to the beneficiary whose entitlement has been excluded or restricted, or
> (b) forgo any payment or other benefit to which he would otherwise be entitled under the trust so as to benefit that beneficiary.

The trust of land trustees cannot require the individual to pay compensation (an occupation rent) to the company under s.13(6) because the company has no statutory occupation right: s.13(6) assumes that compensation can only be required in a case where:

(1) a co-owner had such a right; and
(2) the right was excluded or restricted (which can only be done under s.13(1)).

Section 13(3) TLATA provides another power:

> (3) The trustees of land [i.e. the trust of land trustees] may from time to time impose reasonable conditions on any beneficiary in relation to his occupation of land by reason of his entitlement under s.12.
> …
> (5) The conditions which may be imposed on a beneficiary under subsection (3) include, in particular, conditions requiring him—
> (a) to pay any outgoings or expenses in respect of the land, or
> (b) to assume any other obligation in relation to the land or to any activity which is or is proposed to be conducted there.

The trust of land trustees can do little under s.13(3) except to require the individual to pay outgoings.[42]

It is reasonably clear that ss.12–14 TLATA are a comprehensive code and there is no common law right to an occupation rent except in a case of ouster.

The trust of land trustees also have power to sell the property but the court has discretion either to prevent or to require a sale.[43] The question here is whether the court would require a sale of the property if the individual did not want a sale but the company did. In my opinion a court would not do so, unless either the individual no longer wished/ceased to occupy the property, or the company had a good reason for a sale, e.g. it was insolvent. Section 15(1) TLATA provides:

> The matters to which the court is to have regard in determining an application for an order under s.14 include—
> (a) the intentions of the person or persons (if any) who created the trust,
> (b) the purposes for which the property subject to the trust is held,
> (c) the welfare of any minor who occupies or might reasonably be expected to occupy any land subject to the trust as his home, and
> (d) the interests of any secured creditor of any beneficiary.

None of these factors would support a sale.[44]

In short, the company, although co-owner, can do almost nothing while the individual remains in occupation, except require him to pay the outgoings.

Since this is the case, then the fact that the company does nothing, and

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42 In particular, the trust of land trustees cannot use this power to require the individual to pay an occupation rent, as that must be done under s.13(6) or not at all. Otherwise s.13(6) would be entirely otiose. There is a further restriction in s.13(7) but that is not so important here.

43 Sections 6, 14 TLATA.

44 An individual's position is even stronger if he has more than a 50% share, as s.11(1) TLATA normally gives him further support. This provides:

> "The trustees of land shall in the exercise of any function relating to land subject to the trust—
> (a) so far as practicable, consult the beneficiaries of full age and beneficially entitled to an interest in possession in the land, and
> (b) so far as consistent with the general interest of the trust, give effect to the wishes of those beneficiaries, or (in case of dispute) of the majority (according to the value of their combined interests)."

See too s.15(3) TLATA which requires a court to have regard to the beneficiary with a majority share. But it is not necessary to rely on this.

the individual remains in occupation, does not mean that the company has provided accommodation, or conferred a benefit, in the years in which the individual occupies. This is because the individual has the right of occupation independently of anything the company does or can do.

In *IRC v Eversden*[45] the settlor gave a trustee co-owner a 95% share in a house, the settlor retaining 5%. The settlor continued to occupy. It was held that the trustee had not provided a benefit as the settlor was entitled to occupy. This took place before the TLATA 1996 but the position would be the same under the TLATA.

The matter is made more complicated by *Christensen v Vasili* 76 TC 116. This concerned a co-owned car. The question was whether there was a tax charge under (what is now) s.144 ITEPA which applies where a car is "made available" to an employee. The Special Commissioner held that the car was not made available:

> As co-owners the employer and employee each have the right to use the car, but they each have that right because they are each owners, not because one has "made available" the car to the other.[46]

This conclusion was with respect plainly right, unfortunately it was flatly if unconvincingly rejected in the High Court:

> In their ordinary sense, the question "who made the car available to Mr. Vasili?" must be answered in the sense that his employer did so ...[47]

It is suggested that *Vasili* must be distinguished from the normal co-ownership situation because:

(1) in *Vasili* both employer and employee were entitled to possession of the car: in the co-ownership situation considered here the company is not entitled to occupation;
(2) in *Vasili* the car belonged to the employer before he sold a 5% share to the employee. In that sense the employer made the car available. The position would have been different if the car had been purchased

45 [2002] STC 1109 reported 75 TC 340 under the name *IRC v Greenstock's Executors*.
46 76 TC 116 at p.124, para 22.
47 76 TC 116 at p.131, para 13.

in those shares from the outset.

It is unfortunate that *Eversden* was not cited in *Vasili* since the two cases are difficult to reconcile.

54.22.2 *Employment-related benefit*

It might be argued that the company co-owner provides a benefit other than living accommodation:

(1) If the company is the trustee, by not exercising its powers of sale (or to require the individual co-owner to pay an occupation rent); or
(2) If the company is not sole trustee, by consenting to the trustees not exercising those powers.

There is normally no benefit here because the trustees have no such powers. If there were a benefit, the value of the benefit is "the expense incurred in or in connection with the provision of the benefit". The company incurs no expense, so the value of the benefit for tax purposes is nil.[48]

If the company incurs costs of maintenance, that is an employment related benefit.

54.22.3 *Benefit provided by company entering into co-ownership arrangement*

It follows that the company provides a significant benefit to the individual when and if it uses its funds to acquire a share as co-owner (unless it pays a discounted price for the share). Could this benefit be taxable?[49]

In *IRC v Eversden (Greenstock's Executors)* trustees purchased a 95% share in a house ("Meadows"), and the settlor purchased 5%. The judge said:

48 It is considered that this particular benefit does not "consist of an asset being placed at the disposal of the employee" so the valuation is not in accordance with s.205 ITEPA.

49 This issue does not arise where the company receives its share of the land gratuitously.

> Under the agreement with the trustees (providing as it did for the settlor to pay 5% of the purchase price of Meadows and acquire in consequence a right of occupation) *the trustees conferred on the settlor the right to occupy Meadows for an indefinite period rent free.*[50]
> (Emphasis added)

This took place before the TLATA 1996, but the position would be the same now.

In a case where the company provides its funds towards a joint purchase of a new property, and the individual holds as co-owner, the company has provided a benefit of indefinite rent-free occupation; more accurately the benefit is giving the individual the opportunity to acquire a right to indefinite rent-free occupation at a "knockdown price". The benefit is provided at the time the company completes the contract to purchase the land as co-owner.

The benefit would in principle be chargeable in co-ownership cases under s.87 TCGA or s.731 ITA. Since there are no express valuation rules the charge would be on the market value, which would have to be ascertained as best as one can in the light of the circumstances.

For employment income purposes the position is different. It is arguable that:

(1) The benefit is not the provision of living accommodation.
(2) The value of the benefit for IT purposes is nil because:
    (a) The company incurs no expense in connection with its provision. (The purchase price is not such an expense, because the money going out is matched by a property share coming in.)
    (b) The special valuation rules of ss.205, 206 ITEPA do not apply.

54.22.4 *The HMRC view*

The EI Manual provides at 11414:

> **Living accommodation: Avoidance area: Co-ownership cases**
> [April 2007]

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50 75 TC 340, [2002] STC at p.1129. The point was rightly not appealed. Prior to purchasing Meadows another house in joint ownership had been sold. The position for Meadows would be different if the sale of the first house had been conditional on the purchase of Meadows (the new one), that is, if the settlor only agreed to join in the sale of the first if the trustee agreed to join in the purchase of Meadows.

> In these cases the employer and employee co-own the living accommodation. The usual arrangement is that the employer and employee own the property as tenants in common through a trust.
> A tenant in common has a legal right to use 100% of the property 100% of the time even though a tenant in common may only own a much smaller interest in the property (say 30%). It is argued against us in such a case that the employee's rights to use the living accommodation come from the employee's legal rights as a tenant-in-common. So it is argued that no living accommodation has been provided by reason of the employment.
> There are arguments to support a benefit charge within Part 3 Chapter 5 ITEPA in these cases and the strength of those arguments will depend on the facts of the case. PAYE Technical for any case in which you want to argue the point.[51] Your submission should include a copy of any trust deed under which the land is held.

It is interesting to note that HMRC accept that there is not always a charge in co-ownership cases: "it depends on the facts of the case". That is consistent with the view taken here.

In the context of s.87 TCGA, the current HMRC view is that there is an annual benefit which is the difference between:

(1) the rental value of the property in question; and
(2) the hypothetical rental value of a hypothetical property of a value equal to the proportionate value of the taxpayer's share in the property, i.e. if the taxpayer holds a 50% share, one looks to the rental value of a property worth 50% of the actual property.[52]

But this view is very difficult to defend.

54.23 Other defences to BiK charge

54.23.1 *The caretaker's defence*

Section 99 ITEPA provides:

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51 *Sic*. Presumably a phrase such as "Please submit your papers to ..." was accidentally omitted from the start of this sentence.

52 Private correspondence.

> **Accommodation provided for performance of duties**
> (1) This Chapter does not apply to living accommodation provided for an employee if it is necessary for the proper performance of the employee's duties that the employee should reside in it.
> (2) This Chapter does not apply to living accommodation provided for an employee if—
> (a) it is provided for the better performance of the duties of the employment, and
> (b) the employment is one of the kinds of employment in the case of which it is customary for employers to provide living accommodation for employees.

It has been suggested that one can use this to avoid the charge. The idea is to enter into a contract whereby the individual who is to occupy the property does so as caretaker for the company. This does not work. While it may normally be necessary or customary for a caretaker to reside in accommodation, a person does not become a "caretaker" just by being labelled as such. If the individual is occupying an extremely valuable property with only nominal caretaking duties, this is not the same "type of employment" as a normal caretaker. The EI Manual rightly provides:

> **11342. Living accommodation exemption: Necessary for proper performance of the duties: Types of employee** [December 2005]
> Part 3 Chapter 5 ITEPA does not apply to living accommodation provided for an employee if it is necessary for the proper performance of the duties that the employee live in the accommodation provided (see EI Manual 11341).
> The following types of employee may be accepted as being within the exemption:
> ...
> Caretakers living on the premises. This only covers those with a genuine full time caretaking job. ...

54.23.2 *Payment of rent*

The payment of rent will count as "making good" for the s.105 computation and reduce the s.106 computation. However, this proposal raises the problems of IT on the rent. Also, to reduce the s.106 computation to zero, the rent may have to exceed the market rent, especially for very valuable properties.[53]

54.23.3 *Lease premiums*

The FA 2009 inserts the long and complex provisions of s. 105A, 105B ITEPA 2009, which I will consider in a future edition.

The EIM suggests an argument that premiums should sometimes be treated as rent. This was discussed in detail in the 2008/09 edition of this work, but I expect that HMRC will generally abandon that point now (if indeed they ever took it seriously.)

54.24 Foreign homes relief

Section 100A(1) ITEPA provides a relief which I call "**foreign homes relief**".

> This Chapter does not apply to living accommodation outside the UK provided by a company for a director or other officer of the company ("D") or a member of D's family or household if—
> (a) the company is wholly owned by D or D and other individuals (and no interest in the company is partnership property), and
> (b) the company has been the holding company of the property at all times after the relevant time.

I refer to the company providing the property as "**the provider company**". I refer to the condition in (1)(a) as"**the wholly owned condition"** and the condition in (1)(b) as "**the holding company condition"**. Thus the relief applies where:

(1) The provider company provides accommodation for a director[54] of the provider company ("D") or a member of D's family or household. If the accommodation is provided for an employee who is not a director (or a member of a director's family or household) of the provider

53 By contrast a market rent for the use of chattels will prevent there being a "benefit" for the purposes of the benefit in kind charge on chattels.

54 Or other officer; for brevity references to "directors" in this section include other officers.

company the relief will not apply. In practice that is not likely to matter.

(2) The provider company meets the wholly owned condition.

(3) The provider company meets the holding company condition.

The relief is inserted by the FA 2008 but is backdated. Section 42 FA 2008 provides:

> (2) Subsection (1) [s.100A and 100B ITEPA] is to be treated as always having had effect.
> (3) Section 145 of ICTA (living accommodation provided for employee) is to be treated as never having applied to living accommodation outside the UK provided in circumstances in which, had it been provided on or after 6 April 2003, s.100A(1) of ITEPA 2003 would cause Chapter 5 of Part 3 of ITEPA 2003 (taxable benefits: living accommodation) not to apply.

54.24.1 *Wholly owned condition*

The relief does not apply if any shares in the provider company are held by a trust or partnership, or if some of the shares are held by a company. The position for 100% subsidiaries is considered below.

54.24.2 *Holding company condition*

Before considering the definition of "holding company of the property" it is necessary to set out a subsidiary definition. Section 100A(4) ITEPA defines "relevant interest in the property":

> "Relevant interest in the property" means an interest under the law of any territory that confers (or would but for any inferior interest confer) a right to exclusive possession of the property at all times or at certain times.

We can now turn to the definition of "holding company" of the property. Section 100A(2) ITEPA provides:

> The company is "the holding company of the property" when—
> (a) it owns a relevant interest in the property,
> (b) its main or only asset is that interest, and

(c) the only activities undertaken by it are ones that are incidental to its ownership of that interest.

54.24.3 *Subsidiary holding company*

Suppose the property is held via a subsidiary company thus:

Parent company ("P")
|
Subsidiary Co ("S")
|
Property

S is in principle the holding company of the property but it does not meet the wholly owned condition. P is not the holding company of the property within s. 100A(2). However s. 100A(3) ITEPA provides:

> The company is also "the holding company of the property" when—
> (a) a company ("the subsidiary") which is wholly owned by the company [*ie the parent company]* meets the conditions in paras (a) to (c) of subsection (2),
> (b) the company's [*ie the parent company's]* main or only asset is its interest in the subsidiary, and
> (c) the only activities undertaken by the company *[ie the parent company]* are ones that are incidental to its ownership of that interest.

Thus P also qualifies as "the holding company of the property." Strictly this does not help as P is not the company providing the accommodation but in practice the relief is clearly intended to apply here.

54.24.4 *"The relevant time"*

Section 100A(5)(6) ITEPA defines "relevant time":

> (5) "The relevant time" is the time the company first owned a relevant interest in the property; but this is subject to subsection (6).
> (6) If—
> (a) none of D's interest in the company was acquired directly or

indirectly from a person connected with D, and
(b) the company owned a relevant interest in the property at the time D first acquired an interest in the company,
"the relevant time" is the time D first acquired such an interest.

54.24.5 *Exceptions*

Section 100B ITEPA sets out three wide exceptions to this narrow relief:

> (1) Section 100A(1) does not apply if subsection (2), (3) or (4) applies.

The first two exceptions concern connected[55] companies:

> (2) This subsection applies if—
> (a) the company's interest in the property was acquired[56] (directly or indirectly) from a connected company at an undervalue, or
> (b) the company's interest in the property derives from an interest[57] that was so acquired.
> (3) This subsection applies if, at any time after the relevant time—
> (a) expenditure in respect of the property has been incurred (directly or indirectly) by a connected company, or
> (b) any borrowing of the company (directly or indirectly) from a connected company has been outstanding (but see subsection (7). ...
> (7) For the purposes of subsection (3)(b), no account is to be taken of—
> (a) any borrowing at a commercial rate, or
> (b) any borrowing which results in D being treated under Chapter

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55 "Connected" is very widely defined in s.100B(9) ITEPA:
> "In this section 'connected company' means—
> (a) a company connected with D, with a member of D's family or with an employer of D, or
> (b) a company connected with such a company."

56 Section 100B(5) ITEPA provides a commonsense definition:
> "In subsection (2), references to the acquisition of an interest include the grant of an interest."

57 Section 100B(6) ITEPA provides a commonsense definition:
> "For the purposes of that subsection [subsection (2)], an interest is acquired at an undervalue if the total consideration for it is less than that which might reasonably have been expected to be obtained on a disposal of the interest on the open market; and "consideration" here means consideration provided at any time (and, for example, includes payments by way of rent)."

7 (taxable benefits: loans) as receiving earnings.

Lastly there is an all-purpose tax motive restriction:

> (4) This subsection applies if the living accommodation is provided in pursuance of an arrangement[58] the main purpose, or one of the main purposes, of which is the avoidance of tax or national insurance contributions.

54.24.6 *Commentary*

Foreign homes relief would serve as a case study for what has gone wrong with tax reform in recent years. Almost every restriction on this relief is anomalous. Why should there be a relief for a company owning land and not for chattels? Yachts and aeroplanes are generally held through companies. Why should the relief apply to companies held by individuals and not by trusts? We need rationalisation and simplification, not yet another narrowly targeted relief. But there it is.

54.25 Benefit in kind: remittance basis taxpayer

This section deals with the position of a remittance basis taxpayer who is an employee, director or shadow director and receives the benefit in kind of living accommodation.

A specified amount (the cash equivalent) "is treated as earnings from the employment". I refer to this as "BiK earnings".

54.25.1 *Are BiK earnings "chargeable overseas earnings"?*

BiK earnings qualify as "chargeable overseas earnings" if (in short) the duties of the employment are performed wholly outside the UK.[59] Thus one has to ascertain:

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58 Section 100B(8) ITEPA provides an unnecessary definition (this seems now to be in the Parliamentary drafter's handbook):

> "In subsection (4) "arrangement" includes any scheme, agreement or understanding, whether or not enforceable."

59 See 12.3 (Chargeable overseas earnings).

(1) what the duties are;
(2) where they are performed.

To ascertain the duties of an employee or formally appointed director is straightforward. To ascertain the duties of a shadow director is problematic. A shadow director has no positive "duties" in the normal sense of the word.

It might be argued that a shadow director has no "duties" within the meaning of s.23 ITEPA. The consequence would be anomalous.[60] I think a court is not likely to accept this. If a shadow director is deemed to have an employment, it follows that he should be deemed to have some "duties".

The harder question is: exactly what are the (deemed) "duties" of the "employment" of a shadow director? The duties may be regarded as the instructions or directions which he gives to the properly appointed directors.

Another possible view is that everything that the shadow director does for the company (or its assets) is regarded as part of his (deemed) "duties"; or alternatively everything he does if:

(1) he acts with the consent of the formally appointed directors; or
(2) his actions concern matters which would (apart from him) be the responsibility of the actual directors.

Whichever of these is correct, where a company holds a UK dwelling house, it would be difficult in practice for a UK resident foreign domiciled individual to ensure that all his "duties" are performed outside the UK. However, it should be possible in other cases, e.g. where the BiK consists of non-UK situate accommodation or chattels, or for the BiK of employment-related loans. It may help to have a contract of employment which sets out the duties (all of which are to be performed abroad).

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60 (1) Benefits in kind of a UK resident foreign domiciled shadow director would never qualify as chargeable overseas earnings.
(2) Benefits in kind of a non-resident shadow director would never be subject to tax.

54.25.2 *Are BiK earnings remitted to the UK?*

If BiK earnings are "chargeable overseas earnings", they are taxable only if remitted to the UK.

If the accommodation is not in the UK then the BiK earnings are not on any view remitted here.

If the accommodation is in the UK, common sense suggests that there ought to be a charge. But there is a sound technical argument that the deemed earnings cannot be remitted because they do not exist. The tax charge arises only if the earnings are remitted. The property (or the benefit of its occupation) is not the same as the earnings. HMRC may not agree. The EI Manual provides:

> **20508 The benefits code: Expense payments to and benefits provided for a director or employee whose earnings are taxable on remittance**
> The earnings of a director or employee, except in an excluded employment (EI Manual 20007), who is chargeable on remittances to the UK under either s.22 or s.26 ITEPA include
> - expenses payments remitted to the UK
> - expenses paid in the UK
> - *benefits provided or enjoyed in the UK (for example, a motorbike available for use in the UK).*
>
> **40303 Meaning of "remitted to the UK": Benefits in kind and UK-linked debts**
> *Benefits in kind*
> The definition of "remitted to the UK" in s.33 (see EI Manual 40302) includes general earnings used, enjoyed or brought to the UK in a form other than money. *The benefits code as defined by s.63(1) ITEPA provides a number of examples of earnings that are capable of satisfying the definition including taxable benefits arising from the provision of:*
> - *living accommodation*
> - *loans*
> - *cars available for private use.*
>
> (Emphasis added)

This relates to the pre-2008 remittance basis. This view is even harder to defend under the ITA remittance basis because where there is deemed income or gains, the statute specifically deals with the issue by deeming some assets to be derived from those income or gains.

54.26 Benefits in kind: non-resident individual

This section deals with the position of a non-resident individual who is an employee, director or shadow director and receives benefits in kind. Earnings are taxable only in respect of duties performed in the UK.[61] Thus one must ascertain:

(1) what the duties are;
(2) whether the earnings are in respect of the duties;
(3) where the duties are performed.

The question of what (if any) are the "duties" of a shadow director is discussed in the above paragraph. I conclude there are no real duties but there are deemed duties. Are the earnings "in respect of" the deemed duties? It is tentatively suggested that the answer is "no". Certainly if there were no deemed duties there would be no earnings, but that is not enough. The benefit of living accommodation (which the earnings represent) would arise independently of the deemed duties. There is no income tax avoidance possibility here, because in the sort of case where substantial services were provided by a shadow director (as valuable as an actual director) then the earnings could be in respect of the duties.[62]

If I am wrong on "in respect of", but all the "duties" are performed outside the UK, the non-resident shadow director is not subject to tax under the benefit in kind provisions. If some of them are performed here, there is an apportionment. The difficulty of apportionment is immense, which suggests that my interpretation of "in respect of" is the correct one. This conclusion is also consistent with the POA non-residence exemption (though consistency between different tax codes does not count for much).

In practice, so far as the author is aware, HMRC do not assess non-resident individuals on benefits in kind. Of course, in many cases, collection of tax would be problematic. But it is significant that EI Manual para 11413 refers only to UK residents.

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61 See 12.8 (Non-resident employee).

62 See *R v Dimsey & Allen* [2002] 1 AC 509 at [19].

54.27 DTT defence to BiK charge

This section considers whether DTTs may provide a defence to the BiK charge.

It is assumed in this section that although the individual is UK resident,[63] he is treaty-resident in another state ("the foreign state") under the DTT tie-breaker rules. A treaty may well be of assistance in these circumstances.

It is assumed that the foreign state has a DTT with an article in the form of Art. 15 of the OECD Model Treaty; of course the individual treaty will need to be reviewed.

Article 15 provides two reliefs for a person who is treaty-resident in a foreign state and it is necessary to consider them separately.

54.27.1 *Article 15(1)*

Article 15(1) provides:

> 1. Subject to the provisions of Articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

To follow this one must bear in mind which Contracting State is which. It is easier to follow if rewritten with the UK in mind, thus:

> 1. ... salaries, wages and other similar remuneration derived by a resident of a *foreign* Contracting State in respect of an employment shall be taxable only in that *foreign* State unless the employment is exercised in *the UK* [the other Contracting State]. If the employment is so exercised *in the UK*, such remuneration as is derived therefrom may be taxed in *the UK* [that other State].

None of the three exceptions in Arts. 16, 18 or 19 is likely to be in point.

To qualify for relief under Art. 15(1) the following conditions must be

63 Otherwise he would not have a BiK problem.

met.

There must be an employment. A shadow directorship is an employment for UK tax purposes, and it is considered that it counts as an employment for treaty purposes.

The BiK charge must be a tax on "salaries, wages and other similar remuneration." This is the case. The OECD Model Commentary para 2.1 provides:

> Member countries have generally understood the term "salaries, wages and other similar remuneration" to include benefits in kind received in respect of an employment (e.g. stock-options, the use of a residence or automobile, health or life insurance coverage and club memberships).

The BiK must be in respect of the employment: it is considered that this condition is satisfied.

Lastly, the employment must be exercised wholly in the foreign State (in which case full relief is applicable) or at least partly in the foreign state (in which partial relief applies). This is more problematic and in typical cases assuming the employment is exercised at all, it will be exercised at least partly in the UK. If that is the case only partial relief is available under article 15(1).

54.27.2 *Article 15(2)*

If relief is not available under Art.15(1) we turn to Art.15(2). For convenience I set it out as it applies to the UK:

> 2. Notwithstanding the provisions of para 1, remuneration derived by a resident of a *foreign* Contracting State in respect of an employment exercised in *the UK [*the other Contracting State*]* shall be taxable only in the *foreign [*first-mentioned*]* State if:
>
> a) the recipient is present in *the UK [*the other State*]* for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned, and
>
> b) the remuneration is paid by, or on behalf of, an employer who is not a resident of *the UK [*the other State*]*, and
>
> c) the remuneration is not borne by a permanent establishment which the employer has in *the UK [*the other State*]*.

In principle this can offer exemption from the charge on benefits in kind, even if the employment is exercised wholly or partly in the UK. The three conditions in (a) to (c) must be met.

> *(a) the recipient is present in the UK for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned*

Whether this condition is met depends on the facts.

> *(b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the UK*

The employer is of course the company owning the property. The employer will not in principle be UK resident. In fact the BiK is not in the strict sense "paid" but it is suggested that the word should not be strictly construed and this requirement is satisfied.

> *(c) the remuneration is not borne by a permanent establishment which the employer has in the UK*

This condition will be met, since the company will not have a permanent establishment (the UK home is not a permanent establishment as defined.)

Accordingly individuals who are treaty-resident in a contracting state and present in the UK for less than 183 days can qualify for DTT relief under Art. 15(2).

54.28 Other planning possibilities using companies

More complex possibilities involve:

(1) acquiring a property,
(2) granting (say) a ten-year lease to trustees or to the individual, and
(3) transferring the freehold reversion to a company. Watch SDLT.

The living accommodation charge would not apply, because the company would not be providing living accommodation. Similar arrangements can be carried out with options. In practice, arrangements of this complexity would not often be needed.

54.29 Dealing with companies at risk of IT charge

Many company structures have been set up in the past. The risk of a living accommodation charge depends on the facts of every case, but in practice it is often a serious concern. What can be done?

54.29.1 *Planning involving winding-up of the company*

If practical, the safest course is to extract the property from the company so as to put an end to the charge (or risk of a charge) under the benefit in kind rules. One way to do this for trusts, where the occupier has a recognised interest in possession, is to liquidate the company.

The liquidation may give rise to a capital gain which may rule out this course. The property will be in the estate of the life tenant for IHT purposes but in practice that may not be too much of a problem: see 54.1 (Home owned by foreign domiciliary). Another company structure may be entered into later, as set out above.

Another possibility might be for a company to sell the property to the trust, the purchase price remaining outstanding as a loan. In principle the loan is deductible from the value of the property, thus substantially reducing any IHT exposure. See para 47.10 (Deduction for debts of trustees). Watch SDLT. CGT may rule out this course.

Another possibility may be to reimburse the company for the cost of providing the accommodation. Watch the CGT implications.

54.29.2 *Planning not involving winding up the company*

CGT may make it impractical to wind up the company. In that case take stringent steps to ensure that the individual is not a shadow director.

54.30 Dealing with living accommodation enquiries in practice

In practice, as *Al Fayed v Advocate General* frankly reports,[64] shadow directorship arguments before the decision in *R v Dimsey & Allen* were "settled by horse trading as opposed to on any strict statutory basis". It is likely that this will continue to be the case. Except for companies which

64 [2002] STC 910 para 44.

were very carefully set up and run, HMRC will at least be able to exact a sum equal to the cost of litigating the issue before the Tax Tribunal or beyond.

54.31 Living accommodation charge: commentary

Anyone who has followed the text to this point will agree that the law in this area is seriously defective. It is unnecessarily complicated, rests to a large part on formal and informal concessions, and is sometimes so very unfair that HMRC themselves do not seem to exert themselves to act in accordance with the law as correctly set out in their own Manuals. The following reforms would solve these problems:

(1) Abolish the s.105 charge and extend s.106 to cover the first £75,000 of acquisition cost. All the concessions would then drop away.
(2) It would be fair to charge a little less than ORI rates, since residential market rents are less than the official rate of interest.
(3) The application of the charge to shadow directors who do no real work for the company is a nonsense. Given the widespread use of holding companies to hold wealth, *Dimsey & Allen* is arguably one of the worst tax decisions made by the House of Lords in recent times. Simply to abolish the charge (reversing *R v Dimsey & Allen*) would go too far the other way, since it is fair that a shadow director who receives what is in reality remuneration from a company should be charged. The solution is to restrict the rule that any benefit from an employer is deemed to be “by reason of employment”. The deeming should not apply to a shadow director (whose connection with the company may be tenuous). That would strike the right balance.

The present BiK rules are being used by HMRC as a raid on ill-advised taxpayers or as a weapon to discourage IHT planning (placing homes in companies for IHT reasons). The latter is not the purpose for which the BiK rules were designed, and it is not surprising that they do not do this job well.

54.32 Section 731 charge

One should arrange, if possible, that any trust or company holding the home and chattels has no relevant income within s.731 ICTA. Otherwise the use of the property would be a benefit giving rise to an income tax charge on the occupier.[65] This only applies if the benefit is not otherwise chargeable to income tax. If there is a shadow director charge, there is no charge under s.731. One possibility is to arrange that the amount of the shadow director charge is a small one (e.g. by a reimbursement of the company's expenditure). Whatever the charge is, it will avoid a taxable benefit under s.731.

54.33 Transfer pricing and non-resident company holding family home

The transfer pricing provisions of Schedule 28AA ICTA (in short) deem transactions between persons under common control to be at arm's length prices. HMRC accept that transfer pricing applies only to transactions between two "enterprises".[66] Where a non-resident company controlled

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65 See 19.4.4 (Interest-free loan and enjoyment of asset in kind).

66 Accepting the argument of Robert Venables QC in 8 OTR 165. See INTM 432090:

"**432090. The affected persons: Enterprises** [January 2005]

Paragraph 1(1) Schedule 28AA ICTA 1988 refers to provision made or imposed between any two (connected) persons, suggesting a broad scope for the schedule, as the term persons includes bodies corporate, partnerships and individuals. However, paragraph 1(2) and (3) require the actual provision to be compared with the arm's length provision that would have been made between independent enterprises.

Paragraph 2 requires the schedule to be construed in accordance with the OECD model convention, as interpreted by the OECD transfer pricing guidelines. Article 9 of the convention sets out the arm's length principle by reference to conditions made or imposed between enterprises. Article 3 defines enterprise as "the carrying on of any business".

This suggests that Schedule 28AA should be applied only where both parties are enterprises, but that this term should be interpreted broadly. The term encompasses more than trading activity, but a natural interpretation implies an intention to make profit or gain, or to undertake activity in a businesslike or commercial way.

In most situations where Schedule 28AA potentially applies there is likely to be little doubt that both the parties to a provision are enterprises. Situations where this may be less clear include the potential application of the schedule to individuals and to charities. It is clear that both individuals and charities can act in a way that would cause them to be regarded as enterprises. This conclusion will follow whenever a trade is being carried on or in other cases where activity is carried on in an organised way with a view to profit or gain. The nature of the activity and whether it carries a commercial flavour will also be relevant.

It is necessary to consider whether a particular provision to which Schedule 28AA potentially applies is one made between two enterprises. Hence it is possible that different conclusions will follow for different provisions made by the same person–some transactions may be made in a capacity unrelated to an enterprise that is being carried on while others may be made in the context of the enterprise.

Examples –Individuals:

- Participation in the management or control of a company does not in itself constitute the carrying on an enterprise. It follows that the office of director, or other employment by foreign trustees provides accommodation in the UK for the use of a beneficiary rent free, no charge to tax arises since the individual is not an enterprise. Tax Bulletin 46 (April 2000) provides:

> **Will a charge be imputed on a non-resident landlord providing rent-free residential accommodation within the UK to a UK individual who is a participant?**
> It will not be Inland Revenue practice to impute a charge under Sch 28AA in these circumstances.

International Manual INTM432090 [January 2005] provides:

> If a company provides residential accommodation rent free to a participant who just makes personal use of it as their home, transfer pricing rules would not *generally* apply (though other tax rules, eg relating to employee benefit or distributions, might well be relevant).
>
> (Emphasis added)

I do not understand why the text says "generally". The provisions could apply in the (unusual) case where the individual is using the

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by a controlled company would not normally constitute a provision made between two enterprises.

- And if a company provides residential accommodation rent free to a participant who just makes personal use of it as their home, transfer pricing rules would not generally apply (though other tax rules, eg relating to employee benefit or distributions, might well be relevant).
- Similarly, holding investments in a close investment holding company would not constitute an enterprise for the purpose of considering provisions made between the company and the individual.
- Holding properties for rent in general does constitute an enterprise. However, if an individual holds property principally for private purposes, incidental letting activity that is intended to offset costs rather than to generate income is not likely to constitute an enterprise.
- Lending to connected companies may or may not constitute an enterprise. If the activity is undertaken in a businesslike way with a view to generating gains on shares in the company, this is like to be represent a form of enterprise. On the other hand, isolated loans where the intention is to provide long term funding for a family business may well not be made in the context of an enterprise.
- Where an individual is carrying on an enterprise, it follows that the SME exemption will potentially apply, provided the employment and financial limits are met. These limits will apply on an aggregate basis, including the individual and all connected businesses, including those carried on by controlled companies."

accommodation in an enterprise, but that is not "just personal use".

54.34 SDLT on living accommodation charge

Para 12 Sch 4 FA 2003 provides:

> (1) Where a land transaction is entered into by reason of the purchaser's employment, or that of a person connected with him, then—
> (a) if the transaction gives rise to a charge to tax under Chapter 5 of Part 3 of the ITEPA (taxable benefits: living accommodation) and—
> (i) no rent is payable by the purchaser, or
> (ii) the rent payable by the purchaser is less than the cash equivalent of the benefit calculated under s.105 or 106 of that Act,
>
> there shall be taken to be payable by the purchaser as rent an amount equal to the cash equivalent chargeable under those sections;
> (b) if the transaction would give rise to a charge under that Chapter but for s.99 of that Act (accommodation provided for performance of duties), the consideration for the transaction is the actual consideration (if any); ...

This will not usually affect a foreign domiciliary who occupies a UK home through a company, even if the foreign domiciliary is a shadow director and within the BiK provisions. The reasons are:

(1) The acquisition of a licence (as opposed to a lease) is not a land transaction. The distinction between lease and licence is fraught but usually the individual will occupy under licence and not a lease.
(2) Even if the shadow director acquires a lease, he will not usually do so by reason of his employment. The extended definition in the BiK code[67] does not apply here.

54.35 Chattels held by companies

Chattels situate in the UK may be placed in a company for the same reasons as the family home: to make them excluded property. This raises

67 See 54.9 ("By reason of the employment").

IT problems similar but not identical to the living accommodation charge.

54.35.1 *The charge*

The charge is in s.203(1) ITEPA:

> The cash equivalent of an employment-related benefit is to be treated as earnings from the employment for the tax year in which it is provided.

The key expressions are "employment-related benefit" and "cash equivalent".

54.35.2 *Employment-related benefit*

This is defined in s.201(2) ITEPA:

> In this Chapter—
> "benefit" means a benefit[68] or facility of any kind;

There is no benefit – and so no charge – if full consideration is paid for the use of chattels. This is so even if the amount paid is less than the "cash equivalent" as it usually will be; contrast the living accommodation charge. HMRC accept this.[69] EI Manual 21002 provides:

> However, something (other than a loan where special provisions apply, see EIM26101 and EIM26111) which is a "fair bargain" (EIM21004) between the employer and the employee is not a "benefit".

Section 201(2) continues:

> "employment-related benefit" means a benefit, other than an excluded benefit,[70] which is provided in a tax year—

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68 For the meaning of "benefit" see 19.4 (Benefit).

69 HMRC do not argue that the word "facility" applies to a facility which is not a benefit in the ordinary sense. Thus s.201(2) is a non-definition of benefit (it only says that "benefit" means benefit); but non-definitions are quite common in tax legislation.

70 "Excluded benefit" is defined in s.202.

(a) for an employee, or
(b) for a member of an employee's family or household,
by reason of the employment.[71]

54.35.3 *"Cash equivalent" etc*

This is defined in s.203(2) ITEPA:

> The cash equivalent of an employment-related benefit is the cost of the benefit less any part of that cost made good[72] by the employee to the persons providing the benefit.

This takes us to the elaborate definition of "cost of the benefit". The starting point is s.204 ITEPA:

> **Cost of the benefit: basic rule**
> The cost of an employment-related benefit is the expense incurred in or in connection with provision of the benefit (including a proper proportion of any expense relating partly to provision of the benefit and partly to other matters).

There are two exceptions to this basic rule:

(1) asset made available without transfer;
(2) transfer of used or depreciated asset.

Point (2) is not discussed here. The rule in (1) is in s.205 ITEPA:

> **Cost of the benefit: asset made available without transfer**
> (1) The cost of an employment-related benefit ("the taxable benefit") is determined in accordance with this section if—
> (a) the benefit consists in—
> (i) an asset being placed at the disposal of the employee, or at the disposal of a member of the employee's family or household, for the employee's or member's use, or
> (ii) an asset being used wholly or partly for the purposes of the

71 For the definitions of expressions used here see 54.7 ("Employer", "employee" and "employment").
72 "Made good" is discussed at 54.15.2 ("Making good": meaning).

> employee or a member of the employee's family or household, and
>
> (b) there is no transfer of the property in the asset.
>
> (2) The cost of the taxable benefit is the higher of—
>
> (a) the annual value of the use of the asset, and
>
> (b) the annual amount of the sums, if any, paid by those providing the benefit by way of rent or hire charge for the asset,
>
> together with the amount of any additional expense.

This takes us to the definition of "annual value":

> (3) For the purposes of subsection (2), the annual value of the use of an asset is—
>
> (a) in the case of land, its annual rental value;[73]
>
> (b) in any other case, 20% of the market value[74] of the asset at the time when those providing the taxable benefit first applied the asset in the provision of an employment-related benefit (whether or not the person provided with that benefit is also the person provided with the taxable benefit). ...[75]
>
> (4) In this section "additional expense" means the expense incurred in or in connection with provision of the taxable benefit (including a proper proportion of any expense relating partly to provision of the benefit and partly to other matters), other than—
>
> (a) the expense of acquiring or producing the asset incurred by the person to whom the asset belongs, and
>
> (b) any rent or hire charge payable for the asset by those providing the asset.[76]

54.35.4 *Asset available but not used*

EI Manual provides at 21631 [August 2006]:

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73 "Annual rental value" is defined in s.207 ITEPA. This charge only applies to land other than living accommodation, so in practice it is not important.

74 "Market value" is defined in a commonsense way in s.208 ITEPA.

75 There is transitional relief where those providing the taxable benefit first applied the asset in the provision of an employment-related benefit before 6 April 1980.

76 EIM states at 21631:

> This will include expenditure on running costs and could include expenditure on alterations or improvements, repairs, maintenance, etc depending on whether it was incurred for the purpose of providing the benefit. It would not include interest paid on a loan to acquire the asset.

Note that a tax charge may arise if the asset is available for the use of the director or employee. Whether or not it is used is immaterial. This is because the legislation refers to the benefit as being an asset "placed at the disposal of" the employee. Assets commonly placed at the disposal of directors and employees to which the rule applies are yachts, aircraft, paintings, furniture, TV sets and video machines.

This is correct. The EI Manual gives examples:

21633. Particular benefits: Assets placed at the disposal of a director or employee: Example

The following example shows how the chargeable benefit relating to a yacht is calculated. It would apply to all other assets except cars, vans, land and buildings.

Facts

On 6 April a company buys a yacht on the open market for £25,000.

It immediately makes this available for the sole use of a director and his family throughout the tax year.

In the same year the company spends £2,400 on insurance, fuel, maintenance, servicing and mooring charges for the yacht. It also pays £4,500 interest on a loan obtained to purchase the yacht.

The company requires the director to pay £1,500 a year for the use of the yacht.

Calculation of the benefit

The amount chargeable on the director for the benefit from the yacht being made available for his and his family's use is:

	£
"Annual value of the use of" the yacht: 20% of its market value of £25,000	5,000
Running costs borne by the employer	2,400
	7,400
Less "made good" by the director	1,500
Amount of the benefit	5,900

Notes on the example

Note that in the example the "market value" of the yacht is taken as £25,000 as this was the open market price paid by the company immediately before it was first applied as a benefit.[77]

If the company had leased the yacht for £6,000 a year from 6 April, £6,000 would have been substituted for the "annual value of the use of the yacht" of £5,000 shown above (see EIM21630 and EIM21632).

If, exceptionally, the company had leased the yacht for less than the "annual value" of £5,000, the lease rent would have been disregarded. The calculation would have remained as shown in the example above, based on the annual value

77 [Author's Note] This would not be correct if the yacht was purchased new, as market value would be the secondhand value, which is lower.

of £5,000.

The interest paid on the loan to buy the yacht does not enter into the benefit calculation.

21634.

Particular benefits: Assets placed at the disposal of a director or employee: Asset unavailable for part of a year

Where an asset is not available for part of a year the annual value of its use has to be apportioned (s.204 ITEPA 2003).

For instance, if in the example at EIM21633 the yacht is only made available to the director from 6 October, the chargeable benefit is:

- one half (6/12 months) of the annual value of its use plus
- expenditure on the asset by the person providing it from 6 October to the following 5 April less
- any amount made good by the director (see EIM21120).

21635.

Particular benefits: Assets placed at the disposal of a director or employee: Asset also used in the business or by other employees

An apportionment of the full amount of a benefit is required if an asset is made available to two or more directors and employees or is provided partly to the employee as a benefit and is also used partly by the employer in its business (see EIM21200).

For example, if a yacht is made available to two directors and they agree that its availability is shared equally by them, apportion one half of the benefit to each of them. Similarly if the yacht is used partly for business purposes, such as hiring to customers, a proper proportion of the full annual value of its use would not be chargeable.

21636.

Particular benefits: Assets placed at the disposal of a director or employee: Asset used by the employee partly for private purposes and partly for work purposes

When an asset is available for the private use of a director or employee but it also has to be used in the performance of his duties, the director or employee may be able to get relief for the work use. This is accomplished by treating the value of the benefit as if it were expenditure so that the business proportion can qualify for deduction under s.336 to 338 ITEPA 2003 (see EIM31620 onwards). Note that a deduction will not be due if the private and business use of the asset is concurrent, such as a suit of ordinary clothes worn at work (see EIM31660). Only if the use of the asset is at some times exclusively for business, such as a fax machine provided to the employee at home partly for work use, will a part deduction be due (see EIM31661). See example EIM31617.

21637.

Particular benefits: Assets placed at the disposal of a director or employee: Assets used partly for private purposes and partly for work purposes: Mixed use benefit; Background to example in EIM21638 [August 2006]

See EIM21638 for an example of the interaction between:

- the calculation of the cash equivalent of a benefit where an asset is placed at the disposal of a director or employee (s.205(1)(a)(i) ITEPA 2003) and

- making an apportionment of that benefit where it is available to a director and for "other matters" (s.204 ITEPA 2003).

Where a benefit is provided partly for the use of a director or employee and partly for "other matters" the cost of the benefit must be apportioned (see EIM21200) between the different uses.

Note that an asset placed at the disposal of a director or employee represents a benefit (s.205(1)(a)(i)) regardless of the use, if any, to which the director or employee puts the asset. But see EIM21631 for details relating to the two alternative measures of charge and when to apply one or the other.

If the asset is used wholly for business purposes, this does not prevent the provision of the asset representing a benefit. If the business use satisfies the terms of s.365(1) ITEPA 2003, the director or employee will be entitled to a deduction equivalent to the full amount of the benefit, leaving no amount chargeable to tax. **But this is not the same as there being no benefit.** A benefit has been provided but because of the deduction for business use, the chargeable amount has been reduced to nil.

If the benefit is used by a director or employee for private purposes and for business purposes, the business use is not an "other matter" which can be included in the amount of the benefit to be apportioned under Section 204 ITEPA 2003. The full amount of the mixed use of the benefit is chargeable to tax, subject to a deduction under s.365(1) ITEPA 2003 for any business use that meets the conditions of s.336 to 338 ITEPA 2003 (see EIM21210).

On the other hand, use of the asset by other employees, or by the employer company (for example, for transporting goods or customers), or hire to third parties, are "other matters" to be taken into account in an apportionment.

There are no hard and fast rules for calculating the proportion of cost attributable to different uses but the end result should produce an apportionment that is reasonable in the light of the facts of the case and the statutory context in s.204 (see EIM21200).

See the example at EIM21638.

21638.

Particular benefits: Assets placed at the disposal of a director or employee: Assets used partly for private purposes and partly for work: Example
[August 2006]

For some background information relevant to this example see EIM21637.

Facts

- On 6 June a company purchases a 10 seater aircraft for £800,000,
- the principal shareholder of the company and managing director (MD) holds a pilot's licence,
- the plane is kept at an airfield near to both the company premises and the MD's home. It is available to the MD to use at all times – sometimes, at weekends, he decides on the spur of the moment to take a flight on the plane. The plane is not available to any other director or employee unless given specific permission,
- the company incurs costs on the plane of £20,000 for the 9 months from 6 June to 5 April for landing fees, fuel, insurance, etc.,

- when he uses the plane for private purposes the MD reimburses the company £100 per day as a contribution towards the employer's costs.
- Inspection of the logbook for the period 6 June to 5 April (274 days) shows use as follows:
  1. 10 days – by the MD for travel to business meetings
  2. 20 days – by the company (using an outside pilot hired by the day) to deliver sensitive documents to customers in remote locations
  3. 10 days – commercial hire to third parties at £2,000 per day
  4. 10 days – another director of the company wishes to learn to fly and uses the plane for flying lessons with an instructor
  5. 60 days – private use by the MD.

What is the amount of the benefit chargeable on the MD?

Section 205(2)(a) ITEPA 2003 determines that when an asset is placed at the disposal of a director or employee (see EIM21631), the amount of the cash equivalent of the benefit is the annual value (s.205(3)(b)) plus additional expenses.

Annual value of plane (£800,000 × 9/12 × 20%)	£120,000
Additional expenses	£20,000
Total amount of the benefit	£140,000

As the plane is made available for several different purposes, if any of those purposes amounts to an "other matter" (s.204), an apportionment of the benefit may be due. Use by the MD, whether for business or private purposes, is not an "other matter". But use by other employees, or use by the company, are "other matters" – 2, 3 and 4 above which amount to 40 days in total.

The amount of the benefit is based on the 274 days in the year when the plane was available for use. On 40 days it was used for "other matters" and the benefit must be apportioned accordingly. On the remaining 234 days it was entirely at the disposal of the director to use as and when he wished. If the plane was not available to the director, or not solely available to him, on all these days, the calculation of the benefit could be different (see EIM21639(. the calculation of the benefit must be:

- apportioned to take account of these other matters and
- reduced by any amount made good by the MD to the employer.

Total amount of the benefit	£140,000
Less proportion for "other matters" (40/274)	£20,438
Benefit after apportionment	£119,562
Less made good by MD (£100 × 60)	£6,000
Amount of the benefit chargeable	£113,562

Finally, if the director's use of the plane satisfies the terms of s.336 ITEPA 2003 he will be due a deduction under s.365(1) for the amount of expenses on business purposes that could have been deducted if incurred by him. This figure may be quantified based on the facts of the case. In this instance the MD used the plane for a total of 70 days in the year, 10 days for business and 60 days for private purposes. A reasonable basis for calculating the deduction due under s.365(1) may be 10/70 of the chargeable benefit – 10/70 × 113,562 = 16,223.

Less deduction for business use (10/70 days)	£16,223
Amount chargeable on MD	£97,339

> Note it is necessary to use judgement and common sense when determining the amount that would have been deductible for expenses under s.365(1).
> In this case a deduction of approximately £1,600 per day has been allowed for the MD's travel to business meetings. This may seem a large amount but if the alternative is for the company to hire a similar plane for the day at the commercial rate of £2,000, for which the MD paid himself and was later reimbursed by the company, he would be entitled to a deduction for this amount.
> Apart from extreme cases, it is better not to become involved in a debate concerning what form of transport (and at what cost) is suitable for the director to use to attend meetings.
> The other director who uses the plane for flying lessons will also be chargeable on a benefit based on his 10 days private use of the plane.

54.35.5 *Conveyancing issues for chattels*

The Bills of Sale Act 1878 (in short) applies where a person makes a transfer of goods (a "Bill of Sale" is widely defined) and retains possession of the goods. This could apply on a transfer to a trust or to a company. The transfer is void as against the trustees in bankruptcy of the transferor unless the Bill of Sale is registered in a public register. This is to prevent frauds on creditors. However, it really does not matter if a transfer of chattels is void as against a trustee in bankruptcy, in the event that the individual became bankrupt. After all, every gift and transaction at an undervalue can in principle be set aside by a trustee in bankruptcy for two years, under s.339 Insolvency Act 1986, but no-one suggests that has significant tax implications for solvent taxpayers. Thus it is not necessary to register the transfer of the chattels (the "Bill of Sale") under the Act.

54.36 "Person providing benefit"

This is defined in s.209 ITEPA:

> **Meaning of "persons providing benefit"**
> For the purposes of this Chapter the persons providing a benefit are the person or persons at whose cost the benefit is provided.

CHAPTER FIFTY FIVE

PRE-OWNED ASSETS

55.1 Pre-owned assets – Introduction

This chapter considers the provisions in Schedule 15 FA 2004 ("**POA provisions**"). The supplementary regulations (whose title is so long it cannot sensibly be used)[1] are referred to as "**the 2005 POA Regulations**".

The HMRC website gives guidance ("**Website POA Guidance**").[2]

"**The CIOT Statement**" gives HMRC answers to a number of questions raised by CIOT, STEP and LITRG.[3]

The label "pre-owned assets" is convenient but inaccurate since the charge may apply to property not previously owned by the taxpayer.

The provisions impose three charges to income tax which I call:

(1) "**The POA land charge**".
(2) "**The POA chattel charge**".
(3) "**The POA intangible property charge**".

Land, chattel and intangible property are given commonsense definitions.[4]

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1 The Charge to Income Tax by Reference to Enjoyment of Property Previously Owned Regulations 2005.

2 *www.hmrc.gov.uk/poa/index.htm*. This incorporates guidance formerly in a document called "Technical Guidance" (2004).

3 Accessible *www.tax.org.uk/showarticle.pl?id=3839;n=232*. The current version of the statement is dated 31 July 2006; earlier versions were dated 13 October 2005 and 13 March 2006. The process of amendments has left a tangle and it would be better if this statement (and indeed all such statements) were replaced by equally detailed guidance in a HMRC Manual or equivalent.

4 Para 1 Sch 15 FA 2004.

55.2 Human rights

The Parliamentary Joint Committee on Human Rights considered that the POA provisions are compatible with the ECHR except (intriguingly) in relation to the spouse exemptions (which deny relief to cohabitees).[5] This may not be the last word on the subject but the prospect of a successful appeal on human rights grounds seems slender.

55.3 POA land charge

Para 3(1) Sch 15 FA 2004 provides:

> This paragraph applies where—
> (a) an individual ("the chargeable person") occupies any land ("the relevant land"), whether alone or together with other persons, and
> (b) the disposal condition or the contribution condition is met as respects the land.

In the discussion below the "chargeable person" is called "T" and the land he occupies is called "land occupied by T" (rather than "the relevant land").

"Occupation" is a legal concept extensively discussed in rating cases. Website POA Guidance makes some general observations on the meaning of occupation at 4.6.

55.4 The disposal conditions

Para 3(2) Sch 15 FA 2004 provides:

> The disposal condition is that—
> (a) at any time after 17 March 1986 the chargeable person owned an interest—
> (i) in the relevant land, or
> (ii) in other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of an interest in the relevant land, and
> (b) the chargeable person has disposed[6] of all, or part of, his interest in

5 *www.publications.parliament.uk/pa/jt200304/jtselect/jtrights/93/9305.htm.*
6 "Disposal" is defined in para 3(4) Sch 15 FA 2004.

> the relevant land or the other property, otherwise than by an excluded transaction.

This is best regarded as two conditions depending on whether (a) (i) or (ii) applies. I call them disposal conditions (i) and (ii). Only one of them needs to be satisfied for the "disposal condition" to be met.

55.4.1 *Disposal condition (i)*

The essence of disposal condition (i) is that:

> (a) T owned an interest in the land occupied by him.... and
> (b) T has disposed of all, or part of, his interest in the land ...

Disposal condition (i) is aimed at IHT avoidance arrangements (*Eversden*, *Ingram* and double trust schemes) which would not normally be carried out by foreign domiciled individuals. It might, however, apply in many other situations, e.g. if a foreign domiciliary transferred his house to a trust or company.

What if T enters into a contract to purchase land and then assigns that contract to a trust or company? The contract is an interest in land. However, on completion the contract ceases to exist. That will normally be before the valuation date. Since the asset cannot be valued on the valuation date, it is tentatively suggested that disposal condition (1) does not apply in this situation.

The disposal condition is satisfied by a disposal of land for full consideration. However, in such a case the exclusion for arm's length transactions may apply.

55.4.2 *Disposal condition (ii)*

The essence of disposal condition (ii) is that:

> (a) T owned ... other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of an interest in the land occupied by T, and
> (b) T has disposed of all, or part of, his interest in the ... other property ...

Disposal condition (ii) is probably intended to deal with the situation where:

(1) T disposes of land to A.
(2) A sells the land and uses the proceeds to purchase other land occupied by T.

However, it may apply where:

(1) T disposes of any property (not land or cash) to A; and
(2) A disposes of that property and uses the proceeds to purchase land occupied by T.

This overlaps with the contribution conditions. The overlap matters because the excluded transaction defences to the contribution and disposal conditions are not the same.

55.5 The contribution conditions

Para 3(3) Sch 15 FA 2004 provides:

> The contribution condition is that at any time after 17 March 1986 the chargeable person has directly or indirectly provided, otherwise than by an excluded transaction, any of the consideration given by another person for the acquisition of—
> (a) an interest in the relevant land, or
> (b) an interest in any other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of an interest in the relevant land.

This is best regarded as two conditions, depending on whether (a) or (b) applies. I call them contribution conditions (a) and (b). Only one of them need be satisfied for the "contribution condition" to be met.

55.5.1 *Contribution condition (a)*

The essence of contribution condition (a) is that:

> T has directly or indirectly provided…any of the consideration given by another person for the acquisition of ... the land occupied by T …

This envisages that:

(1) "another person" (which may be a company or trustee) acquires for consideration land occupied by T; and
(2) T has provided that consideration directly or indirectly.

55.5.2 *Contribution condition (b)*

The essence of contribution condition (b) is that:

> T has directly or indirectly provided … any of the consideration given by another person for the acquisition of … any other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of ... the land occupied by T.

This applies where:

(1) "another person" ("A") acquires "other property" for consideration.
(2) T has provided that consideration directly or indirectly.
(3) A disposes of the other property.
(4) The proceeds are (directly or indirectly) applied by "another person" (presumably either A himself or another person, "B") towards the acquisition of the land occupied by T.

The drafter may be considering a situation where:

(a) T transfers funds to A who purchases a property; and
(b) A sells that property and uses the proceeds to buy another property occupied by T.

or

(a) T transfers funds to A (e.g. trustees);
(b) A transfers the funds to B (e.g. a company held by A);
(c) B uses the funds to purchase a property occupied by T.

In both those cases I would have said that T had indirectly provided consideration given for the land and contribution condition (a) was already satisfied. I cannot think of a situation which falls within condition (b) and which does not fall within condition (a). But it does not much matter.

55.5.3 *Purpose of contribution conditions*

It is hard to see the purpose of the contribution conditions. *Ingram*, *Eversden* and double trust schemes would be caught by the disposal conditions. Perhaps it was meant to catch schemes set up on the occasion of purchase of a new property where the settlor would provide cash to a trust. But this was never done in the past; it would have been better to frame more targeted anti-avoidance provisions than this blunderbuss approach.

55.6 "Provide"

"Providing" is the fundamental concept in the contribution conditions and it is not an easy one. Some guidance can be found in cases on the meaning of "settlor" where the statutory language is similar.[7]

It is considered that "provide" implies an element of bounty. So if T lends money on arm's length terms to A, who uses the money lent to buy the property, T has not "provided" the consideration and the contribution condition is not satisfied.

What if T lends interest-free to A, who uses the money lent to buy the property? At first sight T has provided the consideration. But it might be argued that A provides the consideration himself (by his promise to repay T) and that T provides nothing.[8] In practice HMRC now[9] accept this.

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7 Some guidance ought to be found from comparable wording in Stamp Duty and SDLT group relief. Unfortunately the SD/SDLT position is even more obscure than the POA: s.27 FA 1967; SP 3/98; para 2(2) Sch 7 FA 2003; Tax Bulletin 70.

8 One might say that T has provided the interest foregone on the loan, but interest foregone does not exist, and it is difficult to see how one could provide something which does not exist.

9 This reverses the view taken in the CIOT Statement:

> "6.2 The meaning of the "provision" of "consideration" in the context of the contribution condition needs to be clarified. On the basis of the case law the word provided suggests some element of bounty.
>
> On this basis our view is that if there is a transfer of Whiteacre by A (or another asset) to his son at full market value which is then sold by son and the sale proceeds used to purchase Blackacre for A to occupy this is a breach of the disposal but not the contribution condition because it lacks the necessary element of bounty.
>
> Similarly the provision of a loan on commercial terms by A to his son to enable son to purchase a house which A then occupies in our view does not fall within the contribution condition.

Website POA Guidance provides at 1.2.1:

> HMRC do not regard the contribution condition set out in Schedule 15, para 3(3) as being met where a lender resides in property purchased by another with money loaned to him by the lender. Our view is that since the outstanding debt will form part of his estate for IHT purposes,
> [1] it would not be reasonable to consider that the loan falls within the contribution condition
> [2] [and therefore not reasonably attributable to the consideration (Sch 15, para 4(2)(c)],[10]

Question 32
Do HMRC agree with this analysis?
HMRC answer to question 32
In our view, it is arguable that the contribution condition does not depend on a degree of bounty for its application. If, on the contrary, a degree of bounty was necessary, might not the operation of the contribution condition provisions in paras 3(3) and 6(3) of Schedule 15 be circumvented by the relatively simple expedient of A, in your example, providing the wherewithal for the purchase of a house by his son by way of a loan, ostensibly on commercial terms, which is then left outstanding indefinitely?
Having said that, we have considered further the sort of case where a loan is made **and operated** on commercial terms eg a commercial rate of interest is specified and paid and there are provisions for repayment of the loan over the sort of period one would expect to find in a truly commercial loan. Having regard to paras 4(2)(c) or 7(2)(c) of Schedule 15, the chargeable amount would depend on the value of DV in R (or N) x DV/V: that's to say on "such part of the value of the land/chattel as can reasonably be attributed to the consideration provided by the chargeable person." In the case where the loan is on truly commercial terms and conducted in a truly commercial way, we would accept that the attributable amount is nil or de minimis.
In determining "reasonable attribution" for the purposes of para 4(2)(c), it is the terms on which the loan is made and operated that are relevant, as indicated above. In that context, the period over which the loan is repaid as well as whether a commercial rate of interest is charged is relevant.
Thus, where an interest-free loan is repaid over a typical "commercial" period, it would be reasonable to regard the interest foregone as attributable to the consideration provided by the chargeable person. In cases where the principal of the loan was left outstanding indefinitely, such principal could reasonably be regarded as attributable to the consideration provided."

10 Words in square brackets are original. [2] refers to the rule which restricts the charge to "such part of the value of the land which is reasonably attributable to the consideration provided by T" see 55.26.4 (The proportion (DV ÷ V). But if, as HMRC accept, the lender has not provided the consideration, the point in [2] does not arise (unless the lender has provided some consideration and made a loan too).

even where the loan was interest free. It follows that the 'lender', in such an arrangement, would not be caught by a charge under Schedule 15.

What if

(1) T lends interest-free to A,
(2) A purchases the property, and
(3) T later releases the loan or makes a gift to A which A uses to repay the loan (which comes to the same thing)?

Alternatively, more simply, what if:

(1) A purchases the property
(2) T makes a gift to A, or reimburses A for the expense (without being obliged to do so).

If T has not provided the consideration at the time that A purchases the property, he cannot provide it later. However the steps form part of a single arrangement, it can probably be said that A has provided the consideration indirectly, even if slightly belatedly.

What if T subscribes for shares on arm's length terms? Probably T has provided funds to the company

55.6.1 *Arrangements involving third parties*

The position becomes more complex where more than two persons are involved.

Suppose T provides funds to A, an individual, who gives them to B, an individual, and B purchases the property. It is suggested that T has not provided the consideration if the "clean break" test is satisfied.[11]

Suppose T provides funds to a trust, who lend them to a company owned by the trust, which purchases the property. It is suggested that T has provided the consideration because the "clean break" test is not satisfied.

What if T gives funds to A and A borrows from a third party on the security of those funds, and uses the borrowed funds to buy the property? It is considered that T has not provided the consideration. If T provides fund X to a company or trust, which borrows fund Y from a third party,

11 See 58.4.1 (When is A an indirect settlor?).

and the company or trust uses both funds to acquire the property, then T has provided fund X but not fund Y.

Traditional IHT planning for a foreign domiciliary's residence will often satisfy the contribution condition, for instance where:

(1) an individual gives to a trust which purchases the home (without a company);
(2) a foreign domiciliary gifts funds to a trust which lends interest-free to the company which acquires the home.

In most cases one exemption or another will apply but it is possible to fall between the gaps.

55.6.2 *Provision of funds for purpose of acquisition*

What is the position if T provides funds but not for the purpose of the acquisition of the land? Suppose:

(1) In 1987 T created a trust. At the time he had no plans to move to the UK.
(2) In 2005 the trustees finance by interest-free loan a company which purchases a property which T occupies.

The foreign domiciled individual has directly provided the property for the purposes of the trust. He is probably to be regarded as having indirectly provided the consideration given for the acquisition of the land under the principle in *Muir v Muir*.[12] So contribution condition (a) is satisfied.

But if T gives funds to A, an individual, and A later uses those funds to buy a property, it is suggested that T has not provided the consideration, unless the two steps form a single arrangement.

55.6.3 *Guarantees*

Para 17 Sch 15 FA 2004 provides:

12 [1943] AC 468. This is consistent with para 10(2)(c) Sch 15 FA 2004 which envisages a seven-year gap between the provisions of funds and the occupation of the land. But the contrary view is arguable.

> Where a person ("A") acts as guarantor in respect of a loan made to another person ("B") by a third party in connection with B's acquisition of any property, the mere giving of the guarantee is not to be regarded as the provision by A of consideration for B's acquisition of the property.

It is suggested that this applies even if A provides security for his guarantee or deposits funds with a bank as a back-to-back loan.

What if:

(1) B borrows to purchase property (perhaps with a guarantee by T); and
(2) T later gives funds to B who repays?

If the steps are independent, it is considered that T has not provided the consideration. If, however, the steps form part of a single arrangement, it is suggested that T can be said to have provided the consideration indirectly.

55.6.4 *Secondhand company*

The contribution condition will not be satisfied where:

(1) A has provided funds to a company to purchase a house.
(2) A sells the company to B who occupies the house.

B has not provided the funds for the purchase (unless the two steps form a single arrangement): see 17.8.1 (Purchase of funded company directly).

55.7 POA chattel charge

Para 6 Sch 15 FA 2004 provides:

> (1) This paragraph applies where—
> (a) an individual ("the chargeable person") is in possession of, or has the use of, a chattel, whether alone or together with other persons, and
> (b) the disposal condition or the contribution condition is met as respects the chattel.
> (2) The disposal condition is that—
> (a) at any time after 17 March 1986 the chargeable person had

(whether alone or jointly with others) owned—
(i) the chattel, or
(ii) any other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of the chattel, and
(b) the chargeable person disposed[13] of all or part of his interest in the chattel or other property otherwise than by an excluded transaction.
(3) The contribution condition is that at any time after 17 March 1986 the chargeable person had directly or indirectly provided, otherwise than by an excluded transaction, any of the consideration given by another person for the acquisition of—
(a) the chattel, or
(b) any other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of the chattel

This follows the form of the POA land charge.

55.8 POA intangible property charge

Para 8 Sch 15 FA 2004 provides:

(1) This paragraph applies where—
(a) the terms of a settlement,[14] as they affect any property comprised in the settlement, are such that any income arising from the property would be treated by virtue of section 624 of ITTOIA (income arising under settlement where settlor retains an interest) as income of a person ("the chargeable person") who is for the purposes of Chapter 5 of Part 5 of that Act the settlor,
(b) any such income would be so treated even if section 625(1) of ITTOIA (settlor's retained interest) did not include any reference to the spouse or civil partner of the settlor, and
(c) that property includes any property as respects which the condition in sub-para (2) is met ("the relevant property").
(2) The condition mentioned in sub-para (1)(c) is that the property is

13 "Disposal" is further defined in para 6(4) Sch 15 FA 2004.
14 "Settlement" here has the IHT meaning, not the settlement-arrangement meaning: para 1 Sch 15 FA 2004. See 58.2 (Definitions of "settlement").

> intangible property which is or represents property which the chargeable person settled, or added to the settlement, after 17 March 1986.

In common form settlor-interested discretionary trusts the GWR exemption will apply. If S lends on favourable terms to a settlement from which he is excluded, s.624 probably applies but para 8 does not apply.[15] In common form trusts where the settlor has an IP, the GWR exemption (or before 2006, the estate exemption) will apply. Accordingly, the POA intangible property charge will not usually affect foreign domiciliaries.

The charge does not apply to intangible property held by a company held by a trust, since that is not property comprised in a settlement, and not caught by s.624, but the shares in the company will be intangible property (except perhaps bearer shares?).

The charge is intended to catch *Eversden* schemes marketed by life insurance companies (which will not normally have been carried out by foreign domiciliaries). But it is much wider than that. It applies (in short) to (almost) any settlor-interested trust unless GWR also applies. If A creates a trust to A for life remainder to B absolutely, or to B for life remainder to A absolutely, the charge applies. However, if there is a power of appointment in favour of A, the charge does not apply as in this case there is a GWR. There is no sense in this. Since s.102ZA FA 1986 stops the *Eversden* schemes, the intangible property charge is an anti-avoidance provision that has lost its purpose[16] and only remains as clutter in the tax system which will occasionally trap the unwary (if anyone later notices or cares).

55.9 Excluded transactions

A disposal of property by an excluded transaction is ignored for the disposal conditions; and the provision of property by an excluded transaction is ignored for the contribution conditions. Para 10(1) Sch 15 FA 2004 defines "excluded transaction" for the disposal conditions and para 10(2) Sch 15 FA 2004 defines the phrase for the contribution conditions. Each sub-paragraph contains five categories of excluded

15 Because s.624 only applies because of the loan and not because of the terms of the settlement (in the IHT sense).

16 Except for arrangements made before 22 March 2006.

transaction, making 10 in all. Simplicity was evidently not an important consideration to the drafter of the POA rules.

Excluded transactions are not a defence to the POA intangible property charge.

55.10 Excluded transactions: disposal conditions

55.10.1 *Arm's length transactions*

Para 10(1) Sch 15 FA 2004 provides:

> For the purposes of ... [the disposal condition], the disposal of any property is an "excluded transaction" in relation to any person ("the chargeable person") if—
> (a) it was a disposal of his whole interest in the property, except for any right expressly reserved by him over the property, either—
> (i) by a transaction made at arm's length with a person not connected with him, or
> (ii) by a transaction such as might be expected to be made at arm's length between persons not connected with each other.

There is no equivalent of this category of excluded transaction for the purposes of the contribution conditions. The reason is that a disposal at arm's length is not likely to amount to "providing" consideration.

This is extended to part disposals by reg. 5(1) of the 2005 POA Regulations:

> Para 3 (land) and para 6 (chattels) do not apply to a person in relation to a disposal of part of an interest in any property if—
> (a) the disposal was by a transaction made at arm's length with a person not connected with him;
> (b) the disposal was by a transaction such as might be expected to be made at arm's length between persons not connected with each other, and
> (i)the disposal was for a consideration not in money or in the form of readily convertible assets[17], or
> (ii) the disposal was made before 7 March 2005.

17 Defined in reg.5(2).

One might think the word “not” is included accidentally in reg.5(1)(b)(i) but it was deliberate. A written ministerial statement of 7 March 2005 provides:

> We do not in general think it is appropriate to provide exemption for sales of a part interest which are made otherwise than at arm’s length. If one member of a family needs to raise cash, and another member of the family is willing and able to provide it, there are other and more straightforward ways of structuring this than adopting the form of an equity release transaction.

Very few readers will find that satisfactory. But there it is. The statement continues:

> The point was however made in consultation that some intra-family part disposals can arise from patterns of behaviour adopted for good family or business reasons, for example where a child moves in to care for an aged parent and acquires an equitable interest in their shared home as a corollary of that, or where younger members of a family take over the active role in a family partnership, and in doing so acquire an interest from the partners who preceded them.

What is notable is that the drafter seems to have assumed that these are “transactions such as might be expected to be made at arm’s length between persons not connected with each other”.

The Website POA Guidance states (Appendix 1):

> If Miss B acquired her interest in the property by way of an equitable arrangement rather than for cash – for example, she had given up work to care for Mr A on the understanding that she would receive a share of the property in return – the income tax charge will not apply: Regulation 5
> In considering whether the conditions were satisfied, we would need information about how the essential elements of the transaction had been arrived at. We do recognise that there is a substantial body of case law dealing with the circumstances in which an interest in a house is acquired in consequence of a person acting to his detriment. The Ministerial Statement had these sorts of situations in mind and we would interpret Regulation 5 accordingly. In particular, we accept that the requirement that "the disposal was by a transaction such as might be expected to be made at arm’s length between persons not connected

> with each other" would be interpreted with such cases in mind. Where the parties had sought separate advice and acted upon it or had obtained a court order confirming the property entitlement, that would reinforce the claim that the conditions were satisfied. But we would not expect parties to such an arrangement to have done this. We recognise that detriment that the acquirer can demonstrate he has suffered can provide consideration for the acquisition of the interest and prevent the transaction from being gratuitous.

It is straining credulity to describe this as a transaction that may have been expected to have been made at arm's length. But the legislation was not intended to catch this, and HMRC avoid the problem by informal concession dressed up as a statement of practice.

55.10.2 *Spouse exclusions*

The second and third categories of excluded transaction are in para 10(1)(b) and (c) Sch 15 FA 2004:

> (b) the property was transferred to his spouse or civil partner (or where the transfer has been ordered by a court, to his former spouse or civil partner),
> (c) it was a disposal by way of gift (or, where the transfer is for the benefit of his former spouse or civil partner, in accordance with a court order), by virtue of which the property became settled property in which his spouse or civil partner or former spouse or civil partner is beneficially entitled to an interest in possession.[18]

This applies whether or not the IHT spouse exemption applies on the transfer. The transfer to the spouse need not be by way of gift; but a

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18 This is restricted by para 10(3) Sch 15 FA 2004:

> "A disposal is not an excluded transaction by virtue of sub-para (1)(c) or (2)(b), if the interest in possession of the spouse or civil partner or former spouse or civil partner has come to an end otherwise than on the death of the spouse or civil partner or former spouse or civil partner."

HMRC Website Guidance provides at 1.3.1:

> "In cases where the spouse or civil partner or former spouse or civil partner has become absolutely entitled to the property, we would accept that the benefit of the exclusion is not lost."

disposal to a trust under which a spouse has an interest in possession must be by way of gift if the disposal is to be an excluded transaction. Perhaps the reason is to stop variants of the double trust scheme (which involves a sale of a house to an interest in possession trust for consideration).

55.10.3 *Disposition for maintenance of family*

The fourth category of excluded transaction is in para 10(1)(d) Sch 15 FA 2004:

> the disposal was a disposition falling within section 11 of IHTA (dispositions for maintenance of family).

55.10.4 *Annual exemption and small gifts*

The fifth category of excluded transaction is in para 10(1)(e) Sch 15 FA 2004:

> the disposal is an outright gift[19] to an individual and is for the purposes of IHTA a transfer of value that is wholly exempt by virtue of section 19 (annual exemption) or section 20 (small gifts).

This will include substantial gifts which qualify for 100% BPR or APR.

55.11 Excluded transactions: contribution conditions

55.11.1 *Four exclusions*

Para 10(2) Sch 15 FA 2004 provides:

> For the purposes of ... (the contribution condition) the provision by a person ("the chargeable person") of consideration for another's acquisition of any property is an "excluded transaction" in relation to the chargeable person if—
> (a) the other person was his spouse or civil partner (or, where the transfer has been ordered by the court, his former spouse or civil partner),
> (b) on its acquisition the property became settled property in which his

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19 See 55.12 (Meaning of "outright gift").

spouse or civil partner or former spouse or civil partner is beneficially entitled to an interest in possession.

These are the equivalent of 55.10.2 (Spouse exclusions). The spouse trust exclusion here is wider than the spouse trust exclusion for the disposal condition, as the words "by way of gift" do not appear. The last two exclusions in para 10(2) Sch 15 FA 2004 are:

> (d) the provision of the consideration is a disposition falling within section 11 of IHTA (dispositions for maintenance of family), or
> (e) the provision of the consideration is an outright gift to an individual and is for the purposes of IHTA a transfer of value that is wholly exempt by virtue of section 19 (annual exemption) or section 20 (small gifts).

These are the equivalent of 55.10.3 (Disposition for maintenance of family) and 55.10.4 (Annual exemption and small gifts).

55.11.2 *Outright gift of money*

The remaining exclusion is in para 10(2)(c) Sch 15 FA 2004 where:

> (c) the provision of the consideration constituted an outright gift[20] of money (in sterling or any other currency) by the chargeable person to the other person and was made at least seven years before the earliest date on which the chargeable person met the condition in para 3(1)(a)[21] or, as the case may be, 6(1)(a).[22]

Para (c) applies only to the contribution conditions.

The exemption only applies to gifts of money. I am unable to see any reason for that. Website POA Guidance provides at 1.3.1:

> As the earliest date the conditions can be met is 6 April 2005, any provision of consideration by way of an outright gift of cash made before 6 April 1998 will be an excluded transaction.

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20 See 55.12 (Meaning of "outright gift").
21 i.e. occupies the relevant land.
22 i.e. has possession of the chattels.

55.12 Meaning of "outright gift"

The expression "outright gift" is used in three of the ten categories of excluded transaction:

(1) Outright gifts to individuals within s.19 (annual exemption) or s.20 (small gifts) are excluded transactions for the disposal and contribution conditions.[23]

(2) Outright gifts of money (whether or not to an individual) are excluded for the disposal condition.[24]

"Outright gift" is not defined.[25] Clearly a loan and a subscription for shares is not an outright gift. It is suggested that a gift to a trust from which the settlor is excluded is in principle an outright gift.

It is tentatively suggested that a gift to an irrevocable discretionary trust of which the donor is merely a discretionary beneficiary is an outright gift. It must be envisaged that the donor occupies the land given or the exclusion will not apply.

55.13 Exemptions from charge

Para 11 Sch 15 FA 2004 provides a set of exemptions from the POA charges which (in my terminology) are as follows:

(1) Estate exemptions.
(2) GWR exemptions.
(3) Para 11(5)(b) Sch 15 FA 2004 exemptions (charities and other specialist areas) not discussed here.
(4) Para 11(5)(c) Sch 15 FA 2004 exemption (jointly occupied property) not discussed here.
(5) Full consideration exemption.

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23 See 55.10.4 (Annual exemption and small gifts); 55.11.1 (Four exclusions).

24 See 55.11.2 (Outright gift of money).

25 The term "outright gift" is partially defined in s.626 ITTOIA; see 53.14 (Income tax planning for mixed marriage), but that definition does not apply here.

55.14 "Relevant property"

A key concept in para 11 Sch 15 FA 2004 is "relevant property" defined in para 11(9) Sch 15 FA 2004. The expression has three possible meanings.

In relation to the POA land and chattel charges, "relevant property" means:

> (i) where the disposal condition ... is met, the property disposed of,
> (ii) where the contribution condition ... is met, the property representing the consideration directly or indirectly provided.

In a contribution condition case, the relevant property is the property representing the consideration directly or indirectly provided. Since "provided" is a difficult concept,[26] this is also difficult.

If T gives money to A, who uses it to buy a house, the house represents the consideration provided.

What if T subscribes for shares in A Ltd which purchases the house. Is it the shares or the house which represent the property provided? It is suggested that the relevant property is the house, but the shares may be derived property: see below.

What if T lends money to A interest-free, who purchases a house? Is it the house or the benefit of the loan which represents the consideration provided? In this case HMRC accept that T does not provide the consideration so the contribution condition is not satisfied; but if it mattered, it is suggested that the relevant property is the house and the loan may be derived property.

In relation to the POA intangible property charge, "relevant property" has the meaning given in para 8 Sch 15 FA 2004 (roughly, the settled property).[27]

55.15 Estate exemptions

55.15.1 *Full estate exemption*

Para 11(1) Sch 15 FA 2004 provides that the POA charges:

26 See 55.6 ("Provide").
27 See 55.8 (POA intangible property charge).

> do not apply to a person at a time when his estate for the purposes of IHTA includes—
> (a) the relevant property, or
> (b) other property—
>   (i) which derives its value from the relevant property, and
>   (ii) whose value, so far as attributable to the relevant property, is not substantially less than the value of the relevant property.

I refer to this as "**the estate exemption**" (or "the **full** estate exemption" if necessary to distinguish it from the partial exemption discussed below).

If T transfers funds to a trust under which he has an estate interest in possession, the estate exemption will apply. Transfers on or after 22 March 2006 will not normally give rise to an estate IP, so the exemption is of less importance to post 2006 trusts.

55.15.2 *Partial estate exemption*

Para 11(2) Sch 15 FA 2004 provides:

> Where the estate for the purposes of IHTA of a person to whom para 3, 6 or 8 applies includes property—
> (a) which derives its value from the relevant property, and
> (b) whose value, so far as attributable to the relevant property, is substantially less than the value of the relevant property,
> the appropriate rental value in para 4, the appropriate amount in para 7 or the chargeable amount in para 9 (as the case may be) is to be reduced by such proportion as is reasonable to take account of the inclusion of the property in his estate.

I refer to this as "**the partial estate exemption**".

The concluding words "such proportion as is reasonable to take into account of the inclusion of the property in his estate" are somewhat incoherent. One can speak of "a proportion of a property", but not of "a proportion of an inclusion". Presumably it means: "such proportion as is reasonable to take into account of the property which is included in his estate".

55.16 Derived property

In the following discussion:

(1) "**Fully derived property**" is property falling within para 11(1)(b) Sch 15 FA 2004.[28] That is:

property—

(i) which derives its value from the relevant property, and

(ii) whose value, so far as attributable to the relevant property, is not substantially less than the value of the relevant property.

(2) "**Partly derived property**" is property falling within para 11(2) Sch 15 FA 2004. That is property:

(a) which derives its value from the relevant property, and

(b) whose value, so far as attributable to the relevant property, is substantially less than the value of the relevant property.

Thus there are three steps to decide whether property is "derived property":

(1) Is its value derived from the relevant property (the house)? If so:
(2) Ascertain how far its value is attributable to the house.
(3) Is that value (the value attributable to the house) "substantia6lly[29] less" than the value of the house?

55.16.1 *Derived property: shares*

Suppose T subscribes for shares in a company which buys a house and has no other assets. The shares are fully derived property since:

(1) the shares derive their value from the house (the relevant property); and
(2) the value of the shares is attributable to the house; and
(3) that value is not substantially less than the value of the house.

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28 In para 11 Sch 15 FA 2004 this is simply called "derived property".

29 "Substantially" is, obviously, not a precise word. The Website POA Guidance states at 4.7:

> "The term 'substantially less' is not defined by the legalisation but by analogy with the CGT taper relief rules we would regard a reduction of value of less than 20% as not substantially less for the purposes of this Schedule. [Author's Note: see RI 228.] If the circumstances of a particular case suggest that the 'substantially less' provision should be triggered by a reduction of more or less than 20%, it will be judged on its individual merits."

Suppose the company owns a house and other assets. The context shows that the shares are still to be regarded as fully derived property since:

(1) they derive their value from the house;
(2) their value is to some extent attributable to the house;
(3) their value to that extent is not substantially less than the value of the house.

One might question whether it is the case that the shares derive their value from the house. They derive their value in part from the house and in part from other assets. However, the context shows that that satisfies the condition of para 11(1)(b)(i) Sch 15 FA 2004. Otherwise the condition in para 11(1)(b)(ii) Sch 15 FA 2004 is never satisfied.

Suppose the company owns only the house and is subject to a substantial debt. The shares are not fully derived property as their value is substantially less than the house. The shares are partly derived property.

Suppose the company owns the house and other assets, and is subject to a debt. It is suggested that the shares are fully derived property so long as the amount of the debt is less than the value of the other assets.

The estate exemption applies so long as T retains the shares in his estate. If T gifts half the shares to his spouse the estate exemption ceases to apply and POA land charge is due (but with some relief under the partial estate exemption). HMRC agree. Website POA Guidance provides at 1.3.2:

> For example if Mr B transfers his house to a company wholly owned by him, then provided there are no loans to the company one can say that the value attributable to the company is not less than the value of the house. But if Mr B gave the house to a company which was owned 25% by his wife then the value of the 75% shares he holds would be substantially less than the value of the house.

55.16.2 *Derived property: benefit of loan*

Suppose T lends interest-free to a company which purchases the house and has no other assets. Initially the loan is fully derived property as the shares have no value. The loan derives its value from the house as, if the loan is called in, it could only be paid by the company:

(1) selling the house and using the proceeds of sale, or
(2) borrowing on the strength of the house (in the sense that no lender

would lend if the company did not hold the house) and repaying out of that loan.

Can HMRC argue that:

(1) the loan derives its value from the contractual undertaking that obliges the company to repay; and so
(2) the loan does not derive its value from the underlying property (the house).

Point (1) is correct but point (2) does not follow and is not correct. It is the existence of the house which gives value to the contractual obligation to repay.

If the value of the house increases substantially, the shares and loan (taken together) are fully derived property and taken separately they are partly-derived property.

Unfortunately HMRC disagree. The CIOT Statement provides:

> 6.3 Clarification is requested on the position where a house is owned by a company but the company is funded by way of loan. The concern is over paras 11(1)(b) and 11(3)(b).
>
> **Example 9**
>
> [1] B owns 100 £1 shares in X Limited and otherwise funds it by shareholder loan.
>
> [2] (Or the house is owned by a company held within an interest in possession trust for B and again the funding for the purchase comes by way of loan from trustees to company.)
>
> X Limited buys the house in which B lives. B *prima facie* falls within the para 3 charge.

In fact HMRC accept that case [1] does not fall within the POA land charge because the interest free loan is not providing consideration.[30] The CIOT Statement continues:

> It would appear that para 11(1) protects him. The shares are not

30 See 55.6 ("Provide"). Over time HMRC have softened their stance on a number of POA issues by amending their website POA guidance. One drawback of CIOT/STEP statements of this kind is that they are not susceptible to the same process of reflection and informal easy amendment.

> themselves property which derive much value from the house because they are worth substantially less than the house (see para 11(1)(b)(ii)) but the shares and the loan together are comprised in B's estate and between them indirectly derive their value from the house. On that basis para 11(1) does offer full protection.
>
> **Question 33**
>
> Do HMRC agree with this analysis or do they consider that the loan derives its value from the contractual undertakings that oblige the borrowing company to repay?
>
> It would be odd if there is a POA problem when the company is funded by way of loan but not if it is funded by way of share capital.
>
> *HMRC*
>
> In our view, the loan, albeit an asset of B's estate, is not property that derives its value from the relevant property. However, our response to Q32 above would no doubt be applicable here in appropriate circumstances.[31]

This is plainly wrong and I would be surprised if HMRC tried to defend it if seriously challenged.[32] Website POA Guidance qualifies this view if the loan is charged on the land:

> 1.3.2 ... For example if Mr B transfers his house to a company wholly owned by him, then provided there are no loans to the company one can say that the value attributable to the company is not less than the value of the house. ... If he has lent money to the company and the company holds the house we take the view that the company's value is less than the house unless (possibly) the loan is charged on the house.

The last sentence confuses the value of the loan with the value of the company.

The position is more complicated if T lends to a company which purchases the house and has other assets. Suppose, for example, the company's assets and liabilities consist of a house worth £1m, investments of £1m, and a debt of £1m. It is still plainly the case that the benefit of the debt and the shares taken together are fully derived property. It is suggested that if the debt is charged on the house it derives its value from the house, and if it is not charged then it does not do so (but the shares do

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31 See 55.6 ("Provide").

32 But one could avoid the issue by avoiding loans, e.g. subscribe for redeemable shares, which are commercially equivalent to loans.

derive their value from the house).

What if T lends to a trust which purchases a house? If the loan is on limited recourse terms[33] the loan is fully derived property. It is suggested that the same applies even if the trustees are personally liable for the loan.

55.16.3 *Derived property: equitable interests*

If T transfers property to a trust for A for life, remainder to T, T has a reversionary interest which is derived property. The interest is part of T's estate so the full (or partial) estate exemptions apply (depending on whether the value of the reversionary interest is equal to 80% or more of the value of the trust fund).

It T transfers property to a trust for T for life, remainder to A, T's life interest is derived property but it does not form part of his estate (after 2006) so the estate exemption does not apply.

55.17 Excluded liability rule

Para 11(6) Sch 15 FA 2004 provides a restriction on the estate exemptions:

> Where at any time the value of a person's estate for the purposes of IHTA is reduced by an excluded liability affecting any property...

I call this "**the excluded liability rule**". The effect of the rule if it applies is:

> ... that property is not to be treated for the purposes of sub-para (1) or (2) as comprised in his estate except to the extent that the value of the property exceeds the amount of the excluded liability.

The excluded liability rule only applies for the purposes of the estate and partial estate exemptions. The question of to what extent debts may limit the GWR exemption is discussed at 45.16 (GWR property subject to debt).

33 i.e. the trustees' liability to repay is restricted to the trust assets or their value.

55.17.1 *"Excluded liability"*

The term "excluded liability" is defined in para 11(7) Sch 15 FA 2004:

> For the purposes of sub-para (6) a liability is an excluded liability if—
> (a) the creation of the liability, and
> (b) any transaction
>   [i] by virtue of which the person's estate came to include
>   [A] the relevant property or
>   [B] property which derives its value from the relevant property or
>   [ii] by virtue of which the value of property in his estate came to be derived from the relevant property,
>
> were associated operations, as defined by section 268 of IHTA.

I am unable to think of any liability affecting property which is not associated with the transaction within (b). The definition of associated operations is extremely wide. On a number of occasions where anti-avoidance provisions use the concept of "associated operations" restrictions have been read in by implication. The most recent is *Reynaud v IRC* [1999] STC (SCD) 185. This concerned a gift of shares followed by a sale of those shares, two associated operations. The case considered the definition of "transfer of value". That term includes "a disposition effected by associated operations" which reduces the value of an estate. The Special Commissioners held that associated operations were only relevant if they were part of a scheme contributing to the reduction of the estate. See the decision at [17]. However, the decision was not based on the definition of associated operations. On the contrary, it was accepted that operations which do not form part of a scheme could nevertheless be associated. It was the concept of "*disposition effected by associated operations*" which was held to refer only to operations which formed part of a scheme. That is, the restriction was implied by the context of s.3(3) IHTA, not by the words of s.268.

One could argue that the context of para 11(7) Sch 15 FA 2004 implies a restriction that only associated operations forming part of a scheme are relevant for the definition of excluded liability. This would have to be a purposive construction since the words are not in fact there in para 11(7) Sch 15 FA 2004. But we know that the purpose of para 11(7) Sch 15 FA 2004 is to *catch* double trust plans. The effect of this construction would be to *defeat* the intention of the legislation. The argument asks the Courts to frustrate the actual intention of the legislation. So the argument is unlikely to succeed.

55.17.2 *"Affecting" property*

The rule only applies to a liability which "affects" property. It is suggested that a liability of an individual or company does not affect property of the individual or company unless secured on that property. A liability of a company does not affect the shares of the company (even if it may reduce their value). A liability of a trust does affect the trust property since the trustees have a lien over the trust fund to meet the liability.

55.18 Value of estate "reduced" by liability

The excluded liability rule only applies if the value of a person's estate is "reduced" by a liability. In what circumstances does a liability reduce the value of an estate? Plainly it does not do so if it is disallowed for IHT.[34]

55.18.1 *Trustees borrow from settlor*

What if trustees owe a debt to the life tenant settlor? The liability does not reduce the value of his estate for the same reason as when the debt is owed to the trustees: see 47.7.1 (Debt owed by non-settlor life tenant to trust).

55.18.2 *Trustees borrow from trust company*

What if trustees owe a debt to a company held by the trust? It is considered that the debt does not reduce the life tenant's estate since the benefit of the debt increases the value of the company's shares: the two cancel each other out. (In addition, the GWR exemption will usually apply.)

55.18.3 *Bank borrowing*

What if T (or trustees of a trust in which T has an estate borrow money from a bank or third party? It is considered that his estate is not "reduced" by the liability, since his estate is not reduced by the transaction: the

34 See 44.2 (Liability of individual).

liability is matched by the receipt of the borrowed money. Otherwise the excluded liability rule would apply whenever anyone borrows on the security of his house, which would be absurd.[35]

55.18.4 *Company borrows from individual*

Suppose T lends to a company (owned by T) which purchases the property. The liability is an excluded liability as defined, but so long as T retains the benefit of the debt the excluded liability rule does not apply because the debt does not reduce his estate. What if T gives away the debt? The excluded liability rule does not apply unless the debt is secured because the debt does not affect the property.

55.18.5 *Double trust schemes*

The excluded liability rule was intended to catch double trust schemes. Suppose:

(1) T sells his home to a trust under which he has an interest in possession in return for a debt.

At this point the excluded liability rule does not apply. The liability is an excluded liability as defined.[36] However, the benefit of the debt is in T's estate. It is considered that the value of his estate is not "reduced" by the liability.

(2) T gives the benefit of the debt to his children or to a trust for their benefit.

Is the value of T's estate is now reduced by the liability? One can argue that it is reduced by the gift of the debt, not by the liability. But a purposive construction suggests that this cannot be right.
The provision works as intended.

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35 Admittedly s.162(5) IHTA applies and uses the word "reduced" in connection with the same liability. But the question is not whether the value of an *asset* is reduced, but whether the value of the *estate* is reduced.

36 The transaction by which the person's estate included the house was its purchase not the sale to the trust. The creation of the liability is an associated operation because it affects the same property even if the purchase was many years earlier.

55.18.6 *HMRC view*

The CIOT Statement provides:

> 2.5 A common scenario (both for foreign and UK domiciliaries) is where cash is settled into an interest in possession trust for the donor life tenant. The trustees then buy a house for the donor to live in using the gifted cash plus third party barrowings. Although not a home loan scheme, the legislation appears to affect such arrangements.
>
> **Example 4**
>
> E settles cash of £200,000 into an interest in possession trust for himself in 2003. The trustees purchase a property worth £500,000, borrowing £300,000 from a bank. There are other assets in the trust which can fund the interest but the borrowing is secured on the house which E then occupies.
>
> In these circumstances, one would not expect a POA charge. There is no inheritance tax scheme since the property is part of E's estate and the borrowing is not internal. One would argue that E's estate still includes the house and therefore protection is available under para 11(1). The difficulty is that on one view the loan is an excluded liability within para 11(7) reducing E's estate, albeit it is a loan on commercial terms with a bank.
>
> We would argue that the relevant property for the purposes of para 11 is simply the value of the property net of the commercial borrowing. As this is part of E's estate there is no POA charge.
>
> **Question 13**
>
> Is the above analysis correct?
>
> *HMRC*
>
> We agree with your analysis in para 2.5.

It is quite correct that one would not expect a POA charge, as there is no IHT saving. However, what is the correct analysis of the provisions in this situation? The loan is clearly an excluded liability. It is quite wrong to say that the *property* for the purposes of para 11 Sch 15 FA 2004 is its *value* net of the liability, because that confuses two entirely different things: property and the value of property. It is also wrong to say that the asset for the purposes of para 11 Sch 15 FA 2004 is the asset net of the liability; if one did say that, the legislation would not work at all. The best solution is to say that the liability does not reduce the estate of the individual, E, because E's estate is increased by the proceeds of the loan (as well as being reduced by the liability; the two cancel each other out).

55.19 Reverter to settlor restriction

The FA 2006 introduced a restriction to the estate and GWR exemptions:

> (11) Sub-para (12) applies where at any time—
> (a) the relevant property has ceased to be comprised in a person's estate for the purposes of IHTA 1984, or
> (b) he has directly or indirectly provided any consideration for the acquisition of the relevant property,
> and at any subsequent time the relevant property or any derived[37] property is comprised in his estate for the purposes of IHTA 1984 as a result of section 49(1) of that Act (treatment of interests in possession).
> (12) Where this sub-paragraph applies, the relevant property and any derived property—
> (a) are not to be treated for the purposes of sub-paras (1) and (2) as comprised in his estate at that subsequent time, and
> (b) are not to be treated as falling within sub-para (5) in relation to him at that subsequent time.

I refer to this (somewhat inaccurately) as the "**reverter to settlor restriction**". The effect of para 11(12) Sch 15 FA 2004 is to disapply the estate exemptions and the GWR exemption.

EN FB 2006 explains:

> 17. [The POA] income tax charge was designed to discourage disposals done in a contrived way to avoid IHT. The income tax charge does not therefore apply when the original owner has the property back in their estate for IHT purposes (para 11(1) Schedule 15 – for example, because it has been given back to them), or when it is treated as back in their estate (para 11(5) – for example, because the original transaction is caught by the IHT "gift with reservation" rules).

After this loose and colloquial explanation, the EN continues:

> 18. There is a mismatch between this relief and an existing IHT exemption for the settled property in "reverter-to-settlor" trusts. The property in such a trust is treated as part of the trust beneficiary's estate for IHT purposes, but it is not actually charged when their interest ends.

37 Para 11(13) Sch 15 FA 2004 defines "derived property" in terms which repeat the wording of para 11(1)(b) Sch 15 FA 2004 verbatim.

> 19. In particular, section 54(1) IHTA provides that, when a person who is beneficially entitled to an interest in possession in settled property dies while the settlor is still living, and the property reverts to the settlor, its value is left out of account in determining the value of the person's estate. [The EN summarises ss.53 and 54 IHTA and continues:]
> 20. This can be used to side-step both IHT and the pre-owned asset income tax charge. For example:
> - B owns an asset, say a house, which he wants to carry on using. B gives it to S, who would otherwise inherit on B's death;
> - S then settles an interest in possession in the house back on B for life, with the condition that it reverts to S on B's death;[38]
> - for IHT purposes, B is therefore treated as owning the house by virtue of section 49 IHTA and so para 11(1) Schedule 15 disapplies the "pre-owned asset" charge;
> - however, although the house is part of B's estate for IHT purposes, there is no IHT charge on B's death by virtue of the exemption in section 54(1) IHTA.
>
> 21. This clause is aimed at blocking such avoidance by ensuring that the income tax exemption does not apply where the property in question (or any derived property) is back in the chargeable person's estate for IHT purposes by virtue of their being beneficially entitled to an interest in possession in it.
> 22. However, the clause also provides that, if the chargeable person does not wish to be subject to the income tax charge, they can elect (like other former owners otherwise liable to the "pre-owned asset" charge) that the property should fall back into their estate for IHT purposes. Thus the clause ensures an effective IHT charge in these circumstances by providing that the exemptions in sections 53(3), 53(4) and 54 IHTA will not apply.

Unfortunately there is only a passing resemblance between the terms of para 11(11) Sch 15 FA 2004 and the EN. The reverter to settlor restriction applies wherever a person has an estate in property if:

(1) relevant property has ceased to be comprised in a person's estate; or
(2) he has directly or indirectly provided any consideration for the acquisition of the relevant property.

I refer to this as the "trigger conditions". Trigger condition (2) is a

38 Author's Note: This is not of course generally possible after 22 March 2006.

paraphrase of the contribution condition. So wherever the contribution condition applies, the estate exemption is disapplied. For instance, suppose:

(1) T transfers cash to an IP settlement (before 22 March 2006); and
(2) the trustees acquire a UK residence.

The reverter to settlor restriction applies (even though the reverter to settlor exemption does not apply!) so it appears that the POA charge applies. But HMRC do not agree. Published correspondence between STEP and CIOT provides:

> **STEP letter**
> The potential difficulty with paras 11(11) and 11(12) is that they do not distinguish between reverter to settler trusts and any trust set up between March 1986 and 22 March 2006 where the settlor has a qualifying interest in possession and would in that event be subject to inheritance tax on his death.
> These difficulties arise because paras 11(11) and 11(12) catch not only those transactions where land has been given away and ceased to be comprised in the settlor's estate and then comes back into his estate (condition a above). They also catch transactions where a settlor contributed funds or property to a trust and the trust (or an underlying company) has then used those funds or property representing them to buy the relevant property i.e. the land now occupied (condition b above). There is nothing in the words about "any subsequent time" which suggests that under (b) the property had first to cease to be comprised in his estate before being caught by this provision. Indeed if that was the case the words in (a) would be redundant.
> Are the following cases caught by POAT from 5 December 2005 (the date the change came into effect):
>
> 1. In 1987, A sets up an interest in possession trust for himself into which he gifts his house. If the house is still held by the trustees now there is no POAT charge because nothing has left his estate. However assume that the house has since been sold but he retains an interest in possession. The trust holds a mixture of investments and another house that A occupies. Is para 11(11)(b) satisfied on the basis that A has provided consideration for the acquisition of the land which land has subsequently become comprised in his estate. ...
> 2. B is a foreign domiciliary who before 22 March 2006 set up a discretionary trust into which he transferred cash. He remains a beneficiary of the trust. The trust then funds a company which buys a house or possibly holds UK investments (and B will pay income tax under [s720 ITA] in respect of any UK income). The trust was before 22 March 2006 converted into an interest in possession trust. If there are any UK intangibles or UK property occupied by A which are held by the trustees within the interest in possession structure he is now subject to POAT. Even if one reads "subsequent time" to mean

some time must elapse between the date when the gift is made and the date the property comes back into B's estate this would still not protect B in this example because the trust was originally discretionary.

3. In June 2006, C, a disabled person, sets up a trust for himself that qualifies as a disabled person's interest within s89B IHTA. C puts in cash and the trustees invest in equities or a house that C occupies. C will pay POAT. ...

HMRC response

As I understand your concern, it is that the new para 11(11)(b) in Schedule 15 FA 2004 will catch someone who has settled, say, cash on interest in possession trusts for themselves (either before 22 March 2006, or afterwards if it is a "disabled person's interest") and subsequently occupies property bought by the trustees; or where the property they settled initially has been sold and replaced by other property, while the settlor has retained their interest in possession.

The new paragraph refers to the chargeable person "directly or indirectly [providing] any consideration for the acquisition of the relevant property", and goes on to require that, "at any subsequent time", the relevant property is comprised in the settlor's IHT estate by virtue of their having an interest in possession in it.

In our view, the words "at any subsequent time" should be read as meaning that a POA charge will arise where the consideration leaves the donor's estate, as a result of which that estate is reduced, and later property acquired with such consideration becomes comprised in it again because of their interest in possession. This is consistent with the reasons for Schedule 15.

We do not, therefore, consider that there will be a charge in the scenarios numbered 1 and 3 in your letters, because the assets transferred into trust and any derived assets have always been in the settlor's estate for IHT purposes. We believe that also applies if, in your second scenario, B set up an interest in possession trust from the outset before Budget Day. The taxpayer should self-assess on the basis that no POAT is due and there is therefore no need to put anything about POAT on the tax return or for him to make the election where the settlor has retained an interest in possession throughout and settled the cash or property directly into trust himself (rather than through any other funding vehicle such as another trust). This is because no POAT charge arises under s80 FA 2006.

In summary we do not consider that s.80 FA 2006 has any implications for:

- a settlement of cash on interest in possession trusts for onself made before 22 March 2006, or made by a disabled person on or after that date, after which the trustees purchase a property in which the settlor resides; or
- the settlement of a house in the same way, which is subsequently sold by the trustees and replaced by other investments or another property.

That remains our view, on the basis that the words "at any subsequent time" mean that new para 11(11)(b) Schedule 15 FA 2004 will only be relevant where:

- the consideration in question leaves the donor's estate, as a result of which that estate is reduced; and
- later, property acquired with such consideration becomes comprised in the estate once more by virtue of an interest in possession.

We do not agree that this interpretation makes para 11(11)(a) redundant, since that relates to cases where the disposal condition is met and para 11(11)(b) to cases where the contribution condition is met.

We accept that a POA charge may arise where someone set up a discretionary trust that has subsequently been converted into an interest in possession trust for the benefit of the settlor. (Scenario 2 in your example). However, it remains possible in those circumstances to elect out of the charge. So, take the following example:

- H settles a property on discretionary trusts before 22 March 2006;
- also before that date, the trust is converted into an interest in possession trust for H's benefic, with remainder to his wife, W;
- A POA charge therefore arises because of s.80 FA 2006 but H elects.

As we see it, the effects of the election are:

- the chargeable proportion of the property will be treated as subject to a reservation, but only so far as H is not beneficially entitled to an interest in possession in the property (*para 21(2)(b)(i), Schedule 15 FA 2004*) – i.e. not at all;
- section 102(3) and (4) FA 1986 will apply, but only so far as H is not beneficially entitled to an interest in possession in the property (*para 21(2)(b)(ii)*) – i.e. not at all; and
- the reverter-to-settlor exemptions in s.53(3) and (4) and s.54 IHTA will not apply to the actual interest in possession (*para 21(2)(b)(iii)*).

We do not, therefore, consider that the election affects the availability of spouse exemption on H's interest in possession on his death – or on its termination during his lifetime. That is because, as we have just noted, the election will not cause s.102(3) and (4) FA 86 to apply because of H's interest in possession, so there will be no deemed PET.

55.20 GWR exemptions

55.20.1 *Full GWR exemption*

Para 11(3) and (5) Sch 15 FA 2004 provide:

(3) Paras 3, 6 and 8 do not apply to a person at a time when—
(a) the relevant property, or
(b) any other property—
  (i) which derives its value from the relevant property, and
  (ii) whose value, so far as attributable to the relevant property, is not substantially less than the value of the relevant property,
falls within sub-para (5) in relation to him.
...
(5) Property falls within this sub-paragraph in relation to a person at a time when it—
  (a) would fall to be treated by virtue of any provision of Part 5 of

the 1986 Act (inheritance tax) as property which in relation to him is property subject to a reservation,

(b) would fall to be so treated but for any of paras (d) to (i) of subsection (5) of section 102 of the 1986 Act (certain cases where disposal by way of gift is an exempt transfer for purposes of inheritance tax),

(c) would fall to be so treated but for subsection (4) of section 102B of the 1986 Act (gifts with reservation: share of interest in land), or would have fallen to be so treated but for that subsection if the disposal by way of gift of an undivided share of an interest in land had been made on or after 9 March 1999, or

(d) would fall to be so treated but for section 102C(3) of, and para 6 of Schedule 20 to, the 1986 Act (exclusion of benefit).

In short, the POA charges do not apply to property subject to a reservation. ("**GWR property**").

I refer to this as "**the full GWR exemption**".

The question of whether property is GWR property (subject to a reservation) is considered at 45.2 (Terminology).[39]

Note that property may be GWR property even though it is excluded property. Suppose:

(1) T transfers funds to a discretionary trust under which he is a beneficiary (a GWR).[40]
(2) The trustees lend the funds to a company which purchases a house occupied by T.

The shares and the benefit of the loan are derived property, and are subject to a reservation. This is so even if they are excluded property. So the GWR exemption applies.

A complication arises if T becomes UK domiciled: see 55.25 (Former

39 For this purpose para 11(8) Sch 15 FA 2004 tinkers with the GWR tracing rules:

> "In determining whether any property falls within sub-para (5)(b), (c) or (d) in a case where the contribution condition in para 3(3) or 6(3) is met, para 2(2)(b) of Schedule 20 [FA 1986] (exclusion of gifts of money) is to be disregarded."

The Website POA Guidance gives an example at 4.2.

40 The position is the same for a non-estate IP trust if T is the object of a wide power of appointment (so there is a GWR).

foreign domiciliary).

55.20.2 *Partial GWR exemption*

Para 11(4) Sch 15 FA 2004 provides:

> Where any property which falls within sub-para (5) in relation to a person includes property—
> (a) which derives its value from the relevant property, and
> (b) whose value, so far as attributable to the relevant property, is substantially less than the value of the relevant property,
> the appropriate rental value in para 4, the appropriate amount in para 7 or the chargeable amount in para 9 (as the case may be) is to be reduced by such proportion as is reasonable to take account of that fact.

I refer to this as the "**partial GWR exemption**". It is the equivalent of the partial estate exemption discussed above (except that the words at the end of the subsection are grammatical).

55.21 Full consideration exemption

The full consideration exemption in para 11(5)(d) Sch 15 FA 2004 applies where (in my paraphrase) the relevant property or derived property:

> would fall to be treated as property subject to a reservation but for s.102C(3) and Schedule 20 para 6 FA 1986.

There are two exemptions here:[41]

(1) where the GWR rule would apply but for s.102C(3) FA 1986; and
(2) where the GWR rule would apply but for para 6 Sch. 20 FA 1986.

Section 102C is not discussed here. Para 6(1) Sch 20 FA 1986 provides two exemptions to the GWR rule. The first is:

41 Another possible reading is that the exemption only applies if s.102C(3) and Sch 20 para 6 both apply, i.e. it is not enough that Sch 20 para 6 applies if s.102C(3) does not. But a close reading of s.102C shows that s.102C(3) and para 6 Sch 15 FA 2004 are alternatives. They cannot both apply. *Hansard* confirms this (if it were necessary): HC 7 July 2004 col.881, 900. The Website POA Guidance agrees.

> In determining whether any property which is disposed of by way of gift is enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor and of any benefit to him by contract or otherwise—
> (a) in the case of property which is an interest in land or a chattel, retention or assumption by the donor of actual occupation of the land or actual enjoyment of an incorporeal right over the land, or actual possession of the chattel shall be disregarded if it is for full consideration in money or money's worth ...

I call this the "**full consideration exemption**". This is particularly important in relation to chattels because full consideration would be much less than the deemed income charge. As to the meaning of "full consideration" see RI 55 and the published IR letter of 18 May 1987. At present HMRC argue that the industry standard 1% guideline as the market rent for chattels is too low.

The full consideration exemption only applies if there would otherwise be a GWR. If an individual has carried out an *Eversden* scheme, he will not qualify for the full consideration exemption even if he pays full consideration for use of the land (though the rent paid will reduce the quantum of the POA charge).

The second exemption in para 6(1)(b) Sch 20 is less likely to be important in practice.

55.22 Partnerships

Website POA Guidance provides:

> The treatment of a share of a partnership interest for Schedule 15 purposes follows that applied for IHT purposes. In other words, we do not regard the partnership interest as transparent, and the disposal of a share is unlikely to give rise to a Schedule 15 charge in any circumstances.

This is not a view which bears much examination. If a partnership holds land, a partnership interest is an interest in land, and a disposal of that interest meets the disposal condition.[42] But the legislation was not

42 Contrast the Technical Guidance (2004) which took the correct (if worrying) line that the POA rules in principle apply "if C, an existing partner, brings his son D into partnership"; see the 6th edition of this work, para 43.10.1.

intended to catch partnerships and HMRC avoid the problem by informal concession dressed up as a statement of practice.

55.23 Non-resident taxpayer

Para 12(1) Sch 15 FA 2004 provides:

> This Schedule does not apply in relation to any person for any year of assessment during which he is not resident in the UK.

This is straightforward.

55.24 UK resident foreign domiciliary

Para 12(2) Sch 15 FA 2004 provides:

> Where in any year of assessment a person is resident in the UK but is domiciled[43] outside the UK, this Schedule does not apply to him unless the property falling within para 3(1)(a), 6(1)(a) or 8(1)(c) is situated in the UK.

This provides three exemptions:

(1) exemption to POA land charge where T occupies non-UK situate land;
(2) exemption to POA chattel charge where T uses non-UK situate chattels; or
(3) exemption to POA intangible property charge where intangible property is not UK situate.[44]

Para 12 Sch 15 FA 2004 does not provide exemption where T transfers assets to a non-UK company which holds UK land occupied by T. But the GWR or estate exemption will usually apply.

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43 “Domiciled” is defined in para 12(4) Sch 15 FA 2004:
> “ For the purposes of this paragraph, a person is to be treated as domiciled in the UK at any time only if he would be so treated for the purposes of IHTA.”

44 The exemption (anonymously) does not apply to exempt gilts and AUTs or OEICs which may be excluded property but which are UK situate.

55.25 Former foreign domiciliary

Para 12(3) Sch 15 FA 2004 provides:

> In the application of this Schedule to a person who was at any time domiciled[45] outside the UK, no regard is to be had to any property which is for the purposes of IHTA excluded property in relation to him[46] by virtue of section 48(3)(a) of that Act.[47]

The words "was at any time domiciled outside the UK" refer to a person who was formerly foreign domiciled but who has become UK domiciled. The words do not refer to a person who was and remains foreign domiciled. (The words in isolation could, taken literally, apply in such a case, but the word *was* in para 12(3) Sch 15 FA 2004 is to be contrasted with *is* in para 12(2) Sch 15 FA 2004.)

Suppose:

(1) T (not UK domiciled) creates a discretionary trust of which he is a beneficiary;
(2) The trust holds:
 (a) Non-UK investments.
 (b) A company holding UK property occupied by T.

At this point, the conditions for the POA intangible property charge and the POA land charge are satisfied but the GWR exemption provides relief in both cases.

(3) Suppose T becomes UK deemed domiciled (or actually domiciled).

At first sight T ceases to enjoy the benefit of the GWR and estate exemptions as the trust property is excluded property, so "no regard" is to be had to it.

(1) In relation to the investments, there is still no POA intangible property

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45 See above footnote.

46 The words "in relation to him" are misconceived. Property is excluded property or not excluded; but it cannot be excluded property "in relation to" any particular beneficiary. It is considered that these words should simply be disregarded.

47 The exemption (anonymously) does not apply to exempt gilts and AUTs or OEICs which may be excluded property, but not under s.48(3)(a) IHTA.

charge, since the investments are excluded property, so no regard is to be had to them either.

(2) However, the land is not excluded property, so the POA land charge seems to apply.[48] This was certainly not foreseen at the time the legislation was passed. It is suggested that para 12(3) Sch 15 FA 2004 is, like a deeming provision, to be construed to have effect so far as intended but it was not intended to disapply the GWR and estate exemptions. The modern purposive approach to construction of tax statutes may on this occasion assist the taxpayer. The 17 March 1986 POA start date supports this view. That date shows that the object of the rules is to prevent GWR avoidance, not other kinds of IHT mitigation.

HMRC agree with this view. The CIOT Statement provides at para 7:

> Para 12(3) states that no regard is to be had to excluded property. In a case where a trust settled by a foreign domiciliary owns a UK house through a foreign registered company the shares in the company (and any loan to the company) are excluded property. Concern has been expressed that since para 12(3) says that no regard is to be had to these assets, this in turn means that the shares and loan have to be ignored in applying para 11 and in particular cannot be taken into account in determining whether there is derived property which is in the taxpayer's estate or GWR property in relation to him (which the shares and loans otherwise are). We think that this argument is misconceived but it has been advanced.
>
> **Question 42**
>
> Can HMRC confirm that they agree para 12(3) does not operate in this way and that para 11 can still work to protect the UK house or underlying assets owned by the offshore company in these circumstances?
>
> *HMRC*
>
> We agree with what you say in para 7.1 about the interaction between paras 12(3) and 11.

Website POA Guidance provides at 4.1:

> Para 12(3) of the schedule provides that if any property situated outside the UK became comprised in a settlement when the person settling the property was domiciled outside the UK it will not be subject to the

48 A further tax charge would arise if (as some have argued) T is also caught by the GWR rules on his death; see 45.12 (GWR and excluded property rules).

charge. Even if that person becomes domiciled in the UK at a later date this property will remain excluded from the charge.
Para 12(3) provides that a charge under this Schedule shall not arise in relation to property regarded as excluded by virtue of section 48(3) IHTA'84. We do not regard this provision as having an impact on para 11 in determining whether there is derived property in the taxpayer's estate, or GWR property in relation to him (see foreign domiciliary example in appendix).

55.26 Quantum of charge – land

We find the usual cascade of definitions. Para 3(5) Sch 15 FA 2004 provides:

> Where this paragraph applies to a person in respect of the whole or part of a year of assessment, an amount equal to the chargeable amount determined under para 4 is to be treated as income of his chargeable to income tax.

55.26.1 *The chargeable amount and deductible expenses*

One therefore turns to para 4 Sch 15 FA 2004 to find the quantum of the charge. Para 4(1) Sch 15 FA 2004 provides:

> For any taxable period[49] the chargeable amount in relation to the relevant land is
> [a] the appropriate rental value ... less
> [b] the amount of any payments which, in pursuance of any legal obligation, are made by the chargeable person during the period to the owner of the relevant land in respect of the occupation of the land by the chargeable person.

To obtain a deduction requires good paperwork:

(1) a legal obligation; and
(2) payment to the owner of the relevant land.

---

49 "Taxable period" is defined in a commonsense way in para 4(6) Sch 15 FA 2004:
"In this paragraph—
'the taxable period' means the year of assessment, or part of a year of assessment, during which para 3 applies to the chargeable person."

This is straightforward in an *Eversden* scheme, but who is the "owner" of the land in an *Ingram* scheme (where there is a lease owned by T and a reversion owned by others)? Who is owner of the land in a double trust scheme (where the land is held by trustees)?

55.26.2 *"The appropriate rental value"*

This is defined in para 4(2) Sch 15 FA 2004. This provides:

> The appropriate rental value is R x (DV ÷ V)

In short, R is the **R**ental value; V is the capital **V**alue. DV ÷ V is (in a sense) the chargeable part of that value. **DV** stands, perhaps, for Disposal Value.

55.26.3 *"Rental value"*

R is the rental value of the relevant land for the taxable period. "Rental value" is defined in the same manner as the income tax benefit in kind rule: it means the "annual value". The "annual value" is in turn defined in para 5 Sch 15 FA 2004. That is copied from s.110 ITEPA, except that s.110(3), (4) are omitted. It is here called "the POA Annual Value". The POA Annual Value is defined as the rent which will be payable *on the assumption that the landlord (rather than the tenant) pays for all repairs and insurance*. The normal market rent will be lower than the POA Annual Value, because market practice is that the *tenant* pays the cost of repairs and insurance. The difference between POA annual value and normal market rent will vary from one property to another. The difference would be greater with large properties which are expensive to maintain and insure. In relation to other benefits in kind provisions, such as s.87 TCGA and s.731 ICTA, beneficiaries have sometimes been given the benefit of living accommodation on terms that they are responsible for maintenance and insurance. If the maintenance and insurance cost is substantial, they argue that the value of the benefit is small or sometimes even nil. It was perhaps to avoid these arguments that the legislation was framed in this way. It seems extraordinary if one thinks that the legislation is intended to charge income tax on a benefit in kind. However, the object of the legislation is really to penalise taxpayers who have carried out some IHT planning schemes and so it does make sense.

The wording is derived from rating legislation. There is a substantial case law, and to research this the reader should refer to rating law textbooks.

The reader will recall that the annual value for benefit in kind purposes is by concession taken to be the rateable value.[50] There is no reason to think that this concession will be applied for the POA Annual Value. POA Annual Value is (in short) slightly above market rental value.

55.26.4 *The proportion (DV ÷ V)*

The key expression is DV. Para 4(2) Sch 15 FA 2004 provides:

> DV is—
> (a) in a case falling within para 3(2)(a)(i),[51]
> [i] the value as at the valuation date of the interest in the relevant land that was disposed of as mentioned in para 3(2)(b) by the chargeable person or,
> [ii] where the disposal was a non-exempt sale, the appropriate proportion of that value,
> (b) in a case falling within para 3(2)(a)(ii),[52]
> [i] such part of the value of the relevant land at the valuation date as can reasonably be attributed to the property originally disposed of by the chargeable person or,
> [ii] where the original disposal was a non-exempt sale, to the appropriate proportion of that property, and
> (c) in a case falling within para 3(3),[53] such part of the value of the relevant land at the valuation date as can reasonably be attributed to the consideration provided by the chargeable person, and
> V is the value of the relevant land at the valuation date.

The drafter does not deal with a case falling within the disposal and the contribution condition, e.g. if the individual disposes of an interest in a contract to purchase land to another person and also provides the purchase price.

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50 See 54.15.1 ("Rental value of the accommodation").
51 i.e. disposal condition (i), see 55.4.1 (Disposal condition (i)).
52 i.e. disposal condition (ii), see 55.4.2 (Disposal condition (ii)).
53 i.e. the contribution condition, see 55.5 (The contribution conditions).

55.26.5 *(DV÷V) and the valuation date*

The valuation date is determined by the 2005 POA Regulations. The Consultation Document "Taxation of Pre-Owned Assets: Further Consultation" 16 August 2004 explains:

> 5. In the case of land, the "cash equivalent" of enjoyment in a particular tax year is derived from market rental that would be paid for use of the land over the "taxable period" (that is, the tax year or any shorter period for which the asset is "caught" by Schedule 15). This figure is then scaled down, in cases where the taxpayer's "stake" in the caught asset is less than 100 per cent, in the proportion DV/V, where V is the value of the whole asset on the "valuation date" for the year, and DV is the value reasonably attributable to the taxpayer on that date. In many cases, however, we would expect that taxpayers and their advisors will be able to establish the ratio DV/V from the surrounding circumstances without necessarily establishing the absolute amount of V or DV.

55.26.6 *Non-exempt sale*

Para 4(4) Sch 15 FA 2004 provides a relief for a "non-exempt" sale. Para 4(4) Sch 15 FA 2004 begins with the definition of this term:

> The disposal by the chargeable person of an interest in land is a "non-exempt sale" if (although not an excluded transaction) it was a sale of his whole interest in the property for a consideration paid in money in sterling or any other currency;

The label ("non-exempt sale") is chosen, presumably, because the sale is not an excluded transaction. (Perhaps "non-excluded sale" would have been clearer.)

The relief is given by the method of re-defining "the appropriate proportion" to a smaller amount. Para 4(4) Sch 15 FA 2004 continues:

> and, in relation to a non-exempt sale, "the appropriate proportion" is
> (MV–P) ÷ MV
> where—
> MV is the value of the interest in land at the time of the sale;
> P is the amount paid.

This will not often apply as a sale for full value will usually be an excluded transaction and a sale at an undervalue will probably qualify for the GWR exemption.

55.27 Quantum of charge – chattels

Para 6(5) Sch 15 FA 2004 provides:

> Where this paragraph applies to a person in respect of the whole or part of a year of assessment, an amount equal to the chargeable amount determined under para 7 is to be treated as income of his chargeable to income tax.

55.27.1 *The chargeable amount*

Para 7(1) Sch 15 FA 2004 provides:

> For any taxable period the chargeable amount in relation to any chattel is
> [a] the appropriate amount (as determined under sub-para (2)),
> [b] less the amount of any payments which, in pursuance of any legal obligation, are made by the chargeable person during the period to the owner of the chattel in respect of the possession or use of the chattel by the chargeable person.

This follows the format of the POA land charge.

55.27.2 *The appropriate amount*

Para 7(2) Sch 15 FA 2004 provides:

> The appropriate amount is N x (DV ÷ V)

In short, N is **N**otional interest. DV and V are similar to the POA land charge. In detail:

> N is the amount of the interest that would be payable for the taxable

period[54] if interest were payable at the prescribed rate on an amount equal to the value of the chattel [at][55] the valuation date,

DV is—

(a) in a case falling within para 6(2)(a)(i),

  [i] the value as at the valuation date of the interest in the chattel that was disposed of as mentioned in para 6(2)(b) by the chargeable person or,

  [ii] where the disposal was a non-exempt sale,[56] the appropriate proportion of that value,

(b) in a case falling within para 6(2)(a)(ii),

  [i] such part of the value of the chattel at the valuation date as can reasonably be attributed to the property originally disposed of by the chargeable person or,

  [ii] where the original disposal was a non-exempt sale, to the appropriate proportion of that property, and

(c) in a case falling within para 6(3), such part of the value of the chattel at the valuation date as can reasonably be attributed to the consideration provided by the chargeable person, and

V is the value of the chattel at the valuation date.

55.28 Quantum of charge – intangible property

Para 8(3) Sch 15 FA 2004 provides:

> Where this paragraph applies in respect of the whole or part of a year of assessment, an amount equal to the chargeable amount determined under para 9 is to be treated as income of the chargeable person chargeable to income tax.

55.28.1 *The chargeable amount*

Para 9(1) Sch 15 FA 2004 provides:

> For any taxable period the chargeable amount in relation to the relevant

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54 Para 7(5) Sch 15 FA 2004 provides that "the taxable period" means the year of assessment, or part of a year of assessment, during which para 6 Sch 15 FA 2004 applies to the chargeable person.

55 The statute erroneously reads "as".

56 Non-exempt sale is defined in para 7(3) Sch 15 FA 2004 following the form of the POA land charge: see 55.26.6 (Non-exempt sale).

> property is N minus T

In short, **N** is **N**otional income; **T** is **T**ax payable. In more detail:

> N is the amount of the interest that would be payable for the taxable period[57] if interest were payable at the prescribed rate on an amount equal to the value of the relevant property at the valuation date, and
>
> T is the amount of any income tax or capital gains tax payable by the chargeable person in respect of the taxable period by virtue of any of the following provisions—
> (a) section 461 [ITTOIA],
> (b) section 624 [ITTOIA],
> (c) sections 720 to 730 [ITA],
> (d) section 77 [TCGA], and
> (e) section 86 [TCGA],
> so far as the tax is attributable to the relevant property.

Setting notional income against tax is penal and bizarre, but then, the POA charge is penal and bizarre.

There is no provision for carry forward or back if T exceeds N (but that will be rare).

If foreign income is unremitted and no tax is paid because of the s.624 remittance basis, it is considered that the amount of T is nil.

55.28.2 *The valuation date*

Para 9 Sch 15 FA 2004 continues:

> (2) Regulations may, in relation to any valuation date, provide for a valuation of the relevant property by reference to an earlier valuation date to apply subject to any prescribed adjustments.
> (3) In this paragraph—
> ...
> "the valuation date", in relation to a year of assessment, means such date as may be prescribed.

---

57 Para 9(3) Sch 15 FA 2004 provides:
"'the taxable period' means the year of assessment, or part of a year of assessment, during which para 8 applies to the chargeable person".

The date is prescribed in the 2005 POA Regulations.

55.29 Overlap of land and intangible property charges

Para 18 Sch 15 FA 2004 provides:

> *Persons chargeable under different provisions by reference to same property*
> (1) Where, in any year of assessment, a person ("the chargeable person") is (apart from this paragraph) chargeable to income tax both—
> (a) under para 3 (land) or para 6 (chattels) by reason of his occupation of any land or his possession or use of any chattel, and
> (b) under para 8 (intangible property) by reference to any intangible property which derives its value (whether in whole or part) from the land or the chattel,
> he is to be charged to income tax under whichever provision produces the higher chargeable amount in relation to him.
> (2) Where sub-para (1) applies, only the amount under the paragraph under which he is chargeable is to be taken into account in relation to the chargeable person for the purposes of para 13(2).

55.30 Interaction with benefit in kind charge

Para 19 Sch 15 FA 2004 provides:

> Where, in any year of assessment, a person is (apart from this paragraph) chargeable, in respect of his occupation of any land or his possession or use of any chattel, to income tax both—
> (a) under this Schedule, and
> (b) under Part 3 of ITEPA,
> the provisions of that Part shall have priority and he shall not be chargeable to income tax under this Schedule, except to the extent that the amount chargeable under this Schedule exceeds the amount to be treated as earnings under that Part.

55.31 *De minimis* exemption

The Press Release announcing the POA regime promised "a substantial *de minimis* exemption" (*sic*). This turns out to be £5,000 per annum. Para 13 Sch 15 FA 2004 provides:

> (1) This paragraph applies where, in relation to any person who would (apart from this para) be chargeable under this Schedule for any year of assessment, the aggregate of the amounts specified in sub-para (2) in respect of that year does not exceed £5,000.
> (2) Those amounts are—
> (a) in relation to any land to which para 3 applies in respect of him, the appropriate rental value as determined under para 4(2),
> (b) in relation to any chattel to which para 6 applies in respect of him, the appropriate amount as determined under para 7(2), and
> (c) in relation to any intangible property to which para 8 applies in respect of him, the chargeable amount determined under para 9.
> (3) Where this para applies, the person is not chargeable for that year of assessment under any of the following provisions—
> (a) para 3(5) (land),
> (b) para 6(5) (chattels), or
> (c) para 8(3) (intangible property).

This is significant if annual value is (contrary to my expectation) construed by concession to mean rateable value. It could also be significant where husband and wife entered into IHT planning arrangements jointly, since each have their own separate allowance. The exception applies to the "appropriate rental value", so deductible expenses are not relevant. Another problem here is that the £5,000 limit must be satisfied every year. It is not likely that the "substantial" £5,000 figure will be raised in line with inflation. The *de minimis* limit is not time apportioned so the full £5,000 can be set against a much shorter period of deemed income.

It is therefore necessary to ascertain "the appropriate rental value". That takes us to para 4(2) Sch 15 FA 2004:

> The appropriate rental value is R x (DV/V) where
> R is the rental value of the relevant land *for the taxable period*

The "taxable period" is defined in para 4(6) Sch 15 FA 2004:

> "the taxable period" means the year of assessment, or part of a year of assessment, during which para 3 applies to the chargeable person.

Thus it seems clear that if para 3 Sch 15 FA 2004 only applies for part of the year, the taxable period is reduced, so R is reduced, so the "appropriate rental value" is reduced and so (carrying the chain to the end) the *de* *minimis* exemption may apply. Note that the estate exemption in para 11(1) Sch 15 FA 2004 disapplies para 3 Sch 15 FA 2004: see para 11(1) Sch 15 FA 2004.

55.32 Election out of POA regime

One can elect out of the POA charges at an IHT cost. Para 21 Sch 15 FA 2004 deals with the POA land and chattels charges. Para 22 Sch 15 FA 2004 deals with intangible property. They are not quite the same but for reasons of space I shall only cover the former.

55.32.1 *Conditions for election*

Para 21(1) Sch 15 FA 2004 provides

> This paragraph applies where—
> (a) a person ("the chargeable person") would (apart from this paragraph) be chargeable under para 3 (land) or para 6 (chattels) for any year of assessment ("the initial year") by reference to his enjoyment[58] of any property ("the relevant property"), and
> (b) he has not been chargeable under the paragraph in question in respect of any previous year of assessment by reference to his enjoyment of the relevant property, or of any other property for which the relevant property has been substituted.

If an election is made by mistake (because the POA charge does not in fact apply) it has no effect.

55.32.2 *Effect of election*

Para 21(2) Sch 15 FA 2004 provides:

> The chargeable person may elect in accordance with para 23 that—
> (a) the preceding provisions of this Schedule shall not apply to him

58 "Enjoyment" is defined in para 21(4) Sch 15 FA 2004:
"For the purposes of this paragraph a person 'enjoys' property if—
(a) in the case of an interest in land, he occupies the land, and
(b) in the case of an interest in a chattel, he is in possession of, or has the use of, the chattel."

> during the initial year and subsequent years of assessment by reference to his enjoyment of the relevant property or of any property which may be substituted for the relevant property ...

This disapplies Schedule 15. The price is in sub-para (b):

> ..., but
> (b) so long as the chargeable person continues to enjoy the relevant property or any property which is substituted for the relevant property—
> (i) the chargeable proportion of the property is to be treated for the purposes of Part 5 of FA 1986 (in relation to the chargeable person) as property subject to a reservation, but only so far as the chargeable person is not beneficially entitled to an interest in possession in the property,
> (ii) section 102(3) and (4) of that Act shall apply, but only so far as the chargeable person is not beneficially entitled to an interest in possession in the property, and
> (iii) if the chargeable person is beneficially entitled to an interest in possession in the property, sections 53(3) and (4) and 54 of IHTA 1984 (which deal with cases of property reverting to the settlor etc) shall not apply in relation to the chargeable proportion of the property.

Suppose a former foreign domiciliary makes an election in relation to a discretionary trust of which he is a beneficiary and the property is excluded property. How does s.102(3) apply? See 45.12 (GWR and excluded property).

55.32.3 *The chargeable proportion*

This takes us to the definition of "chargeable proportion" in para 21(3) Sch 15 FA 2004:

> In this paragraph, "the chargeable proportion", in relation to any property, means DV ÷ V
> where DV and V are to be read in accordance with para 4(2) or 7(2), as the case requires, but as if—
> (a) any reference in para 4(2) or 7(2) to the valuation date were a reference—
> (i) in the case of property falling within subsection (3) of section

102 of the Finance Act 1986, to the date of the death of the chargeable person, and
(ii) in the case of property falling within subsection (4) of that section, to the date on which the property ceases to be treated as property subject to a reservation, and
(iii) in the case of property in which the chargeable person is beneficially entitled to an interest in possession, to the date of his death or if his interest comes to an end on an earlier date) that earlier date, and

(b) the transactions to be taken into account in calculating DV included transactions after the time when the election takes effect as well as transactions before that time.

I do not see the purpose or effect of para 21(3)(b) Sch 15 FA 2004. How does this work in the case of an *Ingram* scheme?

55.32.4 *Time limit for election*

Para 23(3) Sch 15 FA 2004 provides:

> The election must be made on or before—
> (a) the relevant filing date, or
> (b) such later date as an officer of Revenue and Customs may, in a particular case, allow..

The key expression is "relevant filing date" which is defined in para 23(1) Sch 15 FA 2004:

> "the relevant filing date" means 31 January in the year of assessment that immediately follows the initial year within the meaning of para 21 or (as the case requires) para 22.

Time runs from when the Schedule begins to apply. Normally that will be 6 April 2005,[59] because in the future no-one will deliberately enter into arrangements caught by the Schedule. But where a person is non-resident or domiciled, the Schedule may not begin to apply until a later time when he becomes UK resident or domiciled, and in such a case time for the

59 Or 6 April 2007 for those caught by the reverter to settlor restriction in the FA 2006; see 55.19 (Reverter to settlor restriction).

election starts at that later time; a sensible rule. The Website POA Guidance discusses when a late election is accepted at 3.4.

55.32.5 *Revocation of election*

Para 23(5) Sch 15 FA 2004 provides:

> The election may be withdrawn or amended, during the life of the chargeable person, at any time on or before the relevant filing date.

This will only be useful in very exceptional circumstances.

55.32.6 *Retrospective effect of election*

Para 23(6) Sch 15 FA 2004 provides:

> Subject to sub-para (5), the election takes effect for the purposes of inheritance tax from the beginning of the initial year within the meaning of para 21 or (as the case requires) para 22 or, if later, the date on which the chargeable person would (but for the election) have first become chargeable under this Schedule by reference to the property to which the election relates.

55.33 Election and *Eversden* schemes

If a client has lost his appetite for IHT planning, it would be better to unwind an *Eversden* scheme than to elect. Unwinding an *Eversden* scheme is straightforward.

By contrast, unwinding double trust schemes needs considerable care. Watch out for Fraud on a Power.

55.34 Election in case of double trust schemes

Suppose:

(1) The client ("H") has entered into a double trust plan: he has sold his home to a trust (before 22 March 2006) ("the property settlement") in return for a debt, and given away the debt.
(2) Under the terms of the property settlement, income is paid to H for life, and then for his widow ("W") after his death.

(3) Suppose first of all that the home has not increased in value, so that the net value of the trust fund of the property settlement is nil.
(4) A POA election has been made.
(5) H is survived by W.

55.34.1 *Effect of election*

The chargeable proportion (here = the whole) of the property:

> is to be treated for the purposes of Part 5 of FA 1986 (in relation to the chargeable person) as property subject to a reservation.

So it is treated as property to which H is beneficially entitled.

However, H is already entitled to the property as he has an interest in possession in it. The property is subject to the debt. Is this taken into account in valuing the estate of H on his death? If so the debt scheme still works! In *IRC v Ayrshire Employers Mutual Insurance Association* 27 TC 331 the House of Lords notoriously said that the legislation had "misfired". But the modern approach of the Courts is to make sure that legislation does not "misfire" if they can. Indeed this approach is not so modern, and in 1965 Lord Diplock criticised the *Ayrshire* decision:

> If the Courts can identify the target of Parliamentary legislation their proper function is to see that it is hit: not merely to record that it has been missed.

55.34.2 *Spouse exemption on death of H*

The IHT spouse exemption provides that the transfer of value deemed to be made on the death of H:

> ... is an exempt transfer to the extent that the value transferred is
> [a] attributable to property which becomes comprised in the estate of the transferor's spouse or civil partner; or
> [b] so far as the value transferred is not so attributable, to the extent that that estate is increased.
>
> See s.18(1) IHTA 1984.

H does not qualify for exemption within [b]. We have to argue that the value transferred is "attributable to property" (the home) "which becomes comprised in the estate of the spouse or civil partner".

Does it? Only subject to the debt. The Revenue may reply that "property" in s.49(1) IHTA means net property and this is supported by *Green v IRC*:

> Section 49(1) IHTA 1984 [deems] the deceased to be beneficially entitled to "the property" in which his life interest subsists. It does not say "net property" (i.e. the value of the property net of trust liabilities) but that is what it must mean, and the parties to this appeal both agree that in practice that is the effect the Revenue gives to the section.

On the facts of the above example, no net property becomes comprised in the estate of the spouse. A purposive construction supports that view. It does not make sense for the spouse exemption to apply there.

The spouse exemption would apply to the extent that the value of the property exceeds the debt.

If the debt were released, the problem disappears and it is clear that the spouse exemption would apply.

55.35 Unwinding existing structures

What is to be done when an existing structure falls within the POA land charge?

Do nothing and pay the tax? A suitable option where the client has a short life expectancy. Mitigate the charge by arranging that maintenance costs are deductible: see 55.26.1 (The chargeable amount and deductible expenses).

Elect out of the POA regime? Generally unattractive: you have the IHT charge on death usually without CGT uplift or spouse exemption on death.[60] Consider it if IHT is a long term problem (middle-aged clients). Perhaps a future Conservative government will scrap these rules in a decade or so's time?

It may be sensible to elect and retain the structure where:

(1) IHT is not a problem (e.g. insurance is inexpensive);
(2) Shadow directorship is not a problem (expect an investigation to

60 See 45.18 (IHT spouse exemption defence to GWR charge on death).

follow the election); and

(3) A sale of the company is envisaged in the short or medium term. See para 55.6.4 (Secondhand company).

In most cases shadow directorship may be a problem; it will usually be better to liquidate the company if IHT, CGT and SDLT issues permit.

Best solution is usually unwinding, or reorganising so as to fall within the estate exemption.

55.36 Is existing scheme validly created?

In *Wolff v Wolff* [2004] STC 1633, a husband and wife entered into a reversionary lease of the property in favour of their daughters for 125 years starting from 2017. Subsequently, the claimants became aware that from 2017 they had no right to stay in the property and were at the mercy of the owners of the lease! The lease was set aside for mistake.

55.37 Commentary

Of course the POA provisions are shot through with anomalies, but not markedly more so than much anti-avoidance legislation. (If it seems worse, it is because new unfairnesses rank more sorely than those to which we have become enured by the passage of time.)

What is the nature of the POA charges? Although the tax charge is imposed under the Income Tax Acts, it is not an income tax (in the sense that it is not a tax on income or in any way relating to income). To put it another way, the provisions impose an income tax charge on income which does not exist. Once it is accepted that income tax should not be charged on an individual who occupies his own property[61] then it is anomalous to charge income tax on the benefit of occupation through a trust or company. And since the POA intangible property charge applies even if the property also produces taxed income, it is obviously not income which Schedule 15 is seeking to tax.

The POA charge might be seen as an erratic *ersatz* annual IHT charge on property which has slipped through the IHT net. However, the quantum of the charge is penal (compared to IHT rates).

The true nature of the POA charge is that it is a penalty for carrying out

61 See Kay and King, *The British Tax System*, 5th ed., 1990, p.80.

IHT planning (and not unwinding it). Hardly anyone is seriously expected to pay it. The object is to force taxpayers (by electing or unwinding) to bring themselves back into the IHT net.[62] The POA rules take the clothes or label of a tax, but – looking beyond the label to the contents – they are not a tax as that word is normally understood. It is well established that a fee, levy or toll may in fact be a tax by another name.[63] Likewise provisions wearing the clothes or label of a tax do not necessarily constitute a tax. This point may be relevant to construction because the principle of construction that penalty provisions are to be strictly construed may have more force than the principle that clear words are required to impose a tax.

The controversial aspect of the provisions is that they are retrospective in effect. (One should avoid semantic – indeed Orwellian – debate about the meaning of "retrospective" and look at the effect.) Retrospective legislation is pernicious when it entails liability for conduct which would have been different if the agent had known of the terms of the existing law. The POA rules are unashamedly targeted at taxpayers who have made the following arrangements since 1986:

(1) *Eversden*[64] schemes;
(2) *Ingram*[65] and similar shearing schemes;
(3) "double trust" schemes.

In 2004 I said:

> This is unprecedented in the UK tax system, which has traditionally allowed taxpayers to plan their affairs more securely on the basis of the law of the day. One may approve of this as an attack on tax avoidance, or disapprove as contrary to the rule of law. Views may divide on party political lines.

Since 2004, however, retrospective tax legislation has become a matter of routine, having been applied to a somewhat arbitrary selection of tax avoidance cases and or simply as second thoughts to (what the need for retrospective legislation shows to be) ill thought out legislation.

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62 And to stop similar arrangements being made in the future.
63 *Re a By-law of the Auckland City Council* [1924] NZLR 907 at p.911.
64 *IRC v Eversden (Greenstock's Executors)* 75 TC 340.
65 *Ingram v IRC* [1999] STC 37.

What should not be controversial is that those carried out *Ingram* schemes were particularly unfairly treated. They entered into a package with an IHT advantage (generally) at a significant CGT cost. Parliament removed the benefit and left them with the cost.

Foreign domiciliary IHT planning using companies to avoid IHT on UK land or chattels were not a target of the POA rules; my guess is that any effect on former foreign domiciliaries is entirely accidental; no-one at all had worked it out as the provisions were frantically amended and re-amended.

Of course, the POA rules will bring some revenue for the Government, though how much is a matter of speculation. Set against the tax raised (whatever it is) and the blow against tax avoidance (however one values or regards that) there are some entries to make on the debit side: the POA rules impose significant costs of compliance and tax planning (for they require taxpayers to incur professional fees in order to rearrange their affairs). They impose the unquantifiable burden of complexity and uncertainty which (combined with unfairness) will lead to an equally unquantifiable loss of taxpayer goodwill. One cannot put a value on that goodwill, but it is essential to successful tax administration.

All in all, it is difficult for anyone who cares about the UK tax system to speak with moderation about the conception, enactment process or administration of the POA provisions. The professional bodies did not seriously try.[66]

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66 "The anti-avoidance Pre-Owned Assets regime ... is: retrospective in its effect, disproportionate to the mischief at which it is purportedly aimed, contrary to taxpayers' legitimate expectations, and arbitrary ... ."
CIOT and ICAEW Tax Faculty (October 2004).

CHAPTER FIFTY SIX

ESTATES OF DECEASED PERSONS - CGT

56.1 Succession law background

On the death of a person domiciled in England and Wales,[1] his property passes to his personal representatives ("**PRs**") who are under a duty to pay the debts of the estate, including taxes. Provided that there are sufficient assets available, they pay pecuniary legacies and transfer property which the deceased has specifically gifted. Finally, they transfer the residue of the estate to the residuary legatees. These transfers are normally done by means of an "assent".

During the period of administration, the PRs alone are said to be entitled to the assets which are comprised in the estate. The residuary legatees have the right to compel due administration of the estate, but it has been repeatedly held by courts of the highest authority that the beneficiaries of the estate have no legal or equitable interest in the assets of the estate.[2] Upon completion of the administration, the residuary legatee becomes entitled to the assets of the estate, and any income which the PRs have not expended in the course of administration. It is possible for PRs to assent specific assets before completion of administration.

Special taxation rules apply during this period of administration. The interplay of the rules produces some curious results where a remittance basis taxpayer is a beneficiary or testator. There can sometimes be considerable scope for tax planning.

I consider CGT and in the following chapter income tax.

The starting point is that PRs are "persons" (though not "individuals")

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1 Further consideration is needed on the death of a person domiciled outside England and Wales.

2 *Lord Sudeley v Attorney-General* [1897] AC 11; this (rather odd) principle was re-affirmed in *CSD v Livingston* [1965] AC 694.

so they are in principle subject to IT and CGT.

Similar issues arise where charities are beneficiaries of estates, as to which see *Taxation of Charities,* Kessler & Brown, Key Haven, 7th ed., 2009 Chapters 32 and 33 (Estates of deceased persons).

56.1.1 *When is administration of estate completed?*

How long does the administration period last? This is a question of succession law, not tax law, but it often arises in tax contexts, including income tax, CGT, and estate duty, and has given rise to a substantial case law.

In *IRC v Aubrey Smith* 15 TC 661 Lord Hanworth MR said at p.672:

> In Lord Sudeley's case, [1897] AC at page 15, Lord Halsbury, then Lord Chancellor, says this:
>
> > The thing that the legatee was entitled to was one-fourth share of a residuary estate, consisting, it may be, of many things; and I think it was fallacious on the part of Mr. Channel to say that the residue was very nearly ascertained, because the question is not only of amount – although I think that of itself would not be sufficient if it were only of amount – but it is a question of substance as well as a question of amount. It is uncertain until the residuary estate has been ascertained of what it will consist:
>
> –and on a further page he says this:
>
> > Until the thing has been ascertained, until the trust fund has been constituted, the thing of which the trustees are the trustees has not been ascertained. Whether you treat them, therefore, as trustees or executors, the same consideration arises. Now, if the only thing that the legatee is entitled to is the fourth share of an ascertained residuary estate, I say that to my mind it is impossible to maintain that the character of any part of that estate can be ascertained so as to make it possess a specific locality until that has happened; it is a condition precedent to know what the residuary estate is, and until that has been ascertained you cannot tell of what it will "consist."
>
> .... I read all those passages because they appear quite clearly to lay down that until the fact is ascertained, or can or ought to be inferred, that the residue has become defined so that the aliquot portion passing to the beneficiary can also be defined, the beneficiary has not, until that time, a definite interest in the sum which will ultimately fall to him. Whatever be the contentions of the Respondent, it appears to me as Lord Haldane said in the case I first cited that it is largely a question of fact.

> ...
> What has to be determined here ... is: Is it clear that the portion of each of the sons is ascertained, or has been ascertained, or is capable of ascertainment, and that ascertainment has been assented to by the executor-trustees?

The important points which emerge from the case law are that PRs continue to hold an asset as PRs until:

(1) they "assent" an asset to a beneficiary; or
(2) the administration of the estate is complete (at which point there is an implied assent). For this purpose:
    (a) The estate must be completely ascertained and remain in the course of administration even though this work is nearly done.
    (b) The fact that debts of the deceased remain unascertained or unpaid is a relevant factor but not decisive.
    (c) The fact that the PRs regard themselves as still administering the estate (producing "estate accounts" and not trust accounts) is a relevant factor but not decisive.
    (d) In a marginal case the issue is said to be one of fact and there seems to be a fairly broad "grey area" in which the courts will not interfere with a decision of the Commissioners.

The CG Manual (published 7/94) provides:

> **30700. Period of administration**
> The period during which the PRs are settling the estate is called a period of administration. The period starts with the death of the deceased person. The date on which it ends is a question of fact which is often difficult to resolve. During this period the liability for Capital Gains Tax on sales of assets from the estate falls on the personal representatives unless they have taken specific steps to vest the ownership of the assets involved in legatees in advance of the sale, see CG30910.
> **30701. Attitude of courts**
> On questions of when administration is complete the Courts look for a construction of the law that leads to an early conclusion of administration. The leading case in this respect is *IRC v Aubrey Smith* 15 TC 661.
> **30702.**
> In his judgement Lord Hanworth MR set out a principle of general application when he said, at the bottom of page 675, top of page 676
>
> > 'The question is, in all cases: has the administration of the Estate reached a point of ripeness at which you can infer an assent, at which you can infer that the residuary estate has been ascertained and that it is outstanding and

not handed over merely for some other reason'.

30703.

On this basis we would normally argue that the period of administration ends when residue has been ascertained, see CG30780+.

30710. Extended period of administration

There are some exceptional cases where all the figures are apparently available to enable residue to be ascertained but it has to be accepted that the period of administration is continuing.

30711. Difficulty in distributing assets

One example is where distributing shares in accordance with legatees' fractional entitlements to residue would result in one legatee receiving a majority shareholding whilst the other legatees would only receive minority holdings. Because of the disparity in values between majority and minority holdings it may be necessary for the personal representatives to apply the rule from *Lloyd's Bank v Duker* [1987] 3 All ER 193. This would require them to sell these shares rather than distributing them in specie.

The period of administration would continue in such a case until the shares were sold and the Capital Gains Tax liability arising to the personal representatives was quantified.

The rule referred to above is of fairly limited application. The fact that a majority shareholding would be broken into minority holdings on distribution should not be accepted as preventing distribution of shares and thus the ending of the period of administration. Nor should minor valuation differences between minority shareholdings passing to the legatees be accepted as covered by the rule in the *Duker* case.

30712. Litigation

The period of administration may also be extended where the distribution of the estate is being challenged. The personal representatives may be unable to distribute the estate pending the outcome of litigation.

30720. Confusion over terminology

Even where ascertainment of residue marks the end of the administration period for Capital Gains Tax purposes, assets may remain in the hands of the personal representatives after that date. They may have to carry out administrative acts regarding transfer of assets to legatees. In some cases they may sell assets. If so they will be doing this as bare trustees for the legatees. Personal representatives and their agents sometimes regard these acts as forming part of the period of administration. This may lead to confusion when references are made to the period of administration.

30721.

Because of the possible confusion it is important to establish precisely what is meant when a reference is made to a period of administration. From the Inland Revenue's side we can try to avoid this confusion for the majority of cases by referring to events as falling before or after residue has been ascertained rather than simply referring to the period of administration.

56.1.2 *Importance of assents*

PRs transfer assets to beneficiaries by means of an "assent". The assent is fundamental, since a sale after an assent to a remittance basis taxpayer may in broad terms be free of CGT and a sale before assent may not. (Conversely a sale by non-resident PRs or PRs with losses may be CGT free and a sale after an asset may be taxable.)

An assent of land in England and Wales must be in writing. An assent of other property may be oral or implied by conduct. No formal written assent is required if (say) shares are simply transferred to the name of a beneficiary by stock transfer form. If a portfolio of shares is registered in the names of PRs (or their nominees), and the legatee wants them to be sold, it may be administratively convenient if an assent is made under which the PRs (or their nominees) become nominees for the legatee. Then the shares can be sold without CGT and without the formality of a transfer of legal title to the legatee.

56.2 Acquisition by PRs

Section 62(1) TCGA provides:

> For the purposes of this Act the assets of which a deceased person was competent to dispose—
> (a) shall be deemed to be acquired on his death by the personal representatives or other person on whom they devolve for a consideration equal to their market value at the date of the death, but
> (b) shall not be deemed to be disposed of by him on his death (whether or not they were the subject of a testamentary disposition).

This is the so-called tax-free uplift on death.

56.3 Transfer from PRs to beneficiaries

Section 62(4) TCGA provides:

> On a person acquiring any asset as legatee (as defined in section 64)—
> (a) no chargeable gain shall accrue to the personal representatives, and
> (b) the legatee shall be treated as if the personal representatives' acquisition of the asset had been his acquisition of it.

Section.64(2) TCGA defines legatee:

> In this Act, unless the context otherwise requires,
> [a] "legatee" includes any person taking under a testamentary disposition or on an intestacy or partial intestacy, whether he takes beneficially or as trustee, and
> [b] a person taking under a donatio mortis causa shall be treated (except for the purposes of section 62) as a legatee and his acquisition as made at the time of the donor's death.

56.3.1 *Appropriation of assets to beneficiary*

Section 64(3) TCGA provides:

> For the purposes of the definition of "legatee" above, and of any reference in this Act to a person acquiring an asset "as legatee", property taken under a testamentary disposition or on an intestacy or partial intestacy includes any asset appropriated by the personal representatives in or towards satisfaction of a pecuniary legacy or any other interest or share in the property devolving under the disposition or intestacy.

Thus, if PRs appropriate assets in satisfaction of a pecuniary legacy, then the beneficiary acquires as legatee. This is so even if the appropriation needs the consent of the beneficiary.[3]

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3 Although for stamp duty purposes that the transfer of the asset to a legatee amounted to a conveyance on sale where the consent of the legatee is required: *Jopling v IRC* [1940] 2 KB 282. CCAB Statement June 1967 provided:

> "The Revenue stated that in their view [TCGA s.62(4)] does not apply in all cases where assets are transferred to beneficiaries in specie. Where assets are appointed by personal representatives to satisfy a legacy in circumstances where such appropriation requires the legatee's consent, ie where the personal representatives do not have (whether by the terms of the will or under the Administration of Estates Act 1925 s.41) powers of appropriation without consent, the Revenue are advised that the acquisition of the asset has a contractual basis and is not strictly an acquisition qua legatee. In practice, however, the disposal of appropriated assets by the personal representatives to a legatee in these circumstances is not treated as an occasion of charge on the personal representatives provided that both they and the legatee agree that the legatee should be treated as acquiring the assets concerned as legatee for the purposes of [TCGA s.62(4)]."

This was written before the enactment of what is now s.64(3) TCGA (by the FA

If the PRs had no power of appropriation, then an "appropriation" could be authorised only on the basis that it was in fact a sale of the asset to a beneficiary coupled with a payment of the legacy by way of set-off. In that case, the beneficiary would acquire as purchaser and not as legatee. Fortunately, PRs will generally have a power of appropriation: see s.41 Administration of Estates Act 1925.

56.3.2 *Appointment to beneficiary by executors under overriding powers*

Where executors exercise a power to appoint trust property to a beneficiary, that beneficiary takes under the appointment "as legatee". This follows from the trust law principle that, for the purposes of the rules relating to perpetuities, where trustees exercise a power of appointment, the deed of appointment is read back into the original trust instrument. It is treated as coming into operation at the date of the instrument that creates the power. See *Muir v Muir* [1943] AC 468; *Pilkington v IRC* 40 TC 416 at 441. This rule has been applied for tax purposes, in a different context, in *Chinn v Collins* the exercise of a power of appointment merely "fills in a blank in the original settlement which left blank how the final distribution of a trust asset was to be made"; see 54 TC 311 at 357.

Quite apart from that, the beneficiary would take as "legatee" in the general sense of the expression. The definition in s.64(2) is inclusive and not a comprehensive definition. The reason that the beneficiaries take as legatee is that they acquire under an assent. They acquire from the PRs acting in their capacity as PRs.

This conclusion is consistent with the general scheme of the TCGA. A person who acquires under an appropriation acquires "as legatee". It would be anomalous if a person who acquired under an appointment would not. (A power of appropriation is sometimes regarded as a dispositive power: *Re Freeston* [1978] Ch 741, though I would not regard that as an essential point.)

In CG Manual 31432–3 (although one might quibble with the language used) it seems that HMRC accept that an appointee acquires as legatee.

56.4 Residence and domicile of PRs for CGT

The definition of "residence" for PRs is different for CGT and for IT.

1969). This brought the law into line with what was formerly HMRC practice.

Section 62(3) TCGA provides:

> In relation to property forming part of the estate of a deceased person
> [a] the PRs shall for the purposes of this Act be treated as being a single and continuing body of persons (distinct from the persons who may from time to time be the PRs), and
> [b] that body shall be treated as having the deceased's residence, ordinary residence, and domicile at the date of death.

The residence and domicile of the PRs in their private capacity is irrelevant.

56.5 Deceased not UK resident

If the deceased was not UK resident at the time of his death (regardless of domicile) the PRs are in principle outside the scope of CGT. The estate is therefore a CGT free vehicle. In principle, it would be desirable to arrange that gains accrue to PRs. If the PRs assent assets to UK residents who sell the assets, the gain on the disposal is chargeable in full or on the remittance basis. If the PRs assent assets to non-resident trustees, who sell the assets, the gain is a s.2(2) amount. (By contrast, assets with losses should be transferred *in specie*.) It is also desirable to extend the administration period as long as possible.

56.5.1 *Is an estate a "settlement" within s.87 TCGA?*

Could gains accruing to non resident PRs be s.2(2) amounts within the scope of s.87 TCGA? That could only be the case if a deceased's estate is a "settlement" for the purposes of s.87. Section 97(7) TCGA provides:

> "settlement" has the meaning given by s.620 of ITTOIA ...

In this book this is called the "settlement-arrangement" definition of settlement.[4] In *IRC v Buchanan* 37 TC 366 at p.374, Lord Goddard, a criminal judge, said:

> I do not think for a minute that a will of a testator comes within section

4 See 58.2 (Definitions of "settlement").

20[5] at all; it is not a settlement to which the Act applies.

Lord Goddard did not expressly say that a will is not a settlement-arrangement but if that is what he meant, the comment was *obiter* and clearly wrong. A deceased's estate is a "settlement" in the sense of "arrangement". There is an element of "bounty" since the testator decides who should benefit (or by not making a will, decides that the intestacy rules should apply). However, Lord Goddard's comment was loyally followed.[6] Accordingly CG Manual 14591 (June 2005) is right to provide:

> A will trust cannot be a Settlement for these purposes [for the purposes of the settlement-arrangement definition].

For this reason a deceased's estate is not a "settlement" within s.87. This is supported by the consideration that an assent by PRs in favour of a beneficiary is not (without a considerable stretch) a capital payment.

Section 87(6) TCGA provides:

> For the purposes of this section a settlement arising under a will or intestacy shall be treated as made by the testator or intestate at the time of death.

This shows that a settlement arising under a will or intestacy is a "settlement" for s.87 purposes.[7]

56.6 Gains accruing to non-resident company held by non-resident PRs

Suppose:

(1) PRs hold a non-resident company.
(2) The company disposes of an asset and realises a gain, which I call "the company gain".

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5 Section 20 FA 1943, the predecessor of s.644 ITTOIA.

6 *Willingdale v Islington Green Investment Co* 48 TC 547 at p.556. (The point was not argued on appeal.)

7 But this only applies once the administration of the estate is completed. Section 97(7) TCGA also showed that, before it was amended by the FA 2006.

56.6.1 *Position of company and PRs*

The company is not subject to tax on the company gain because it is not UK resident. The PRs are participators. But if they are not UK resident, they are not treated as if the company gain had accrued to them. The condition in s.13(2)[a] TCGA is not satisfied.

56.6.2 *Position of legatee*

Assume that under the terms of the will the shares pass to a legatee. Is it possible that the legatee should be treated as if the company gain accrued to the legatee, so that:

(1) the legatee would be subject to tax on the gain under s.13(2) TCGA if UK resident; or
(2) if the legatee is a non-resident trust it would be treated as receiving a s.2(2) amount under s.13(10) TCGA?

The first question is whether, at the time the gain accrues to the company (while the estate is still in the course of administration) the legatee is a participator. Section 13(12) TCGA provides:

> In this section "participator", in relation to a company, has the meaning given by section 417(1) of the Taxes Act for the purposes of Part XI of that Act (close companies).

A legatee is a participator under this definition.[8]

However s.13(3) TCGA (identifying the part of the chargeable gain which is deemed to accrue to the participator) provides:

> That part shall be equal to the proportion of the gain that corresponds to the extent of the participator's *interest* as a participator in the company.

The *Sudeley* and *Livingston* cases[9] decided that residuary[10] beneficiaries

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8 See 63.14.4 (PRs and beneficiaries of estates).

9 See 56.1 (Succession law background).

10 There is however no difference between residuary beneficiaries and specific legatees. The origin of the principle that a residuary legatee has no "interest" in the estate is historical: until the mid 19th century, estates were administered in the

of an estate have no legal or equitable "interest" (in the strict sense) in the assets of the estate. They have the right to enforce its proper administration but that is not an interest in the assets. It is considered that during the course of administration the legatee does not have an "interest" as a participator.[11] Thus it does not matter that he is a participator because nothing can be attributed to him under s.13.

The context can show that the word "interest" can be used in a loose or non-technical sense, to include the rights of a beneficiary in an estate. But there is no reason here to say the word is used loosely or non-technically. My conclusion is supported by the fact that it is not clear what would be the "just and reasonable" apportionment of the gain as between UK resident PRs and legatees.

That is not the end of the matter. Normally, on the completion of the administration of the estate the PRs will assent to the vesting of the shares to the legatee. What is the position of the legatee then?

The legatee is treated as having acquired the shares on the death. Does it follow that the legatee is treated as if he had an interest in the shares, for the purposes of s.13 TCGA, so the legatee is after all treated as if the company gain accrued to him? It is the old question of how far one carries through the deeming.[12] In principle, one carries the deeming all the way and this does follow. However, several difficulties then arise:

(1) Suppose the PRs were UK resident. They would have been taxed in the first instance on the company gain under s.13 TCGA. There is

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ecclesiastical courts and not the Chancery courts. That reasoning would apply to a specific legatee as to a residuary legatee.

11 See *Willingdale v Islington Green Investment Co* 48 TC 547 at p.562D.
The expressions used in s.13(3) are partially defined in s.13(13):

> In this section—
> (a) references to a person's interest as a participator in a company are references to the interest in the company which is represented by all the factors by reference to which he falls to be treated as such a participator; and
> (b) references to the extent of such an interest are references to the proportion of the interests as participators of all the participators in the company (including any who are not resident or ordinarily resident in the UK) which on a just and reasonable apportionment is represented by that interest.

Section 13(13)(a) does not turn the legatee's right into an "interest" if it is not already an interest.

12 See 45.11.1 (Construction of deeming provisions).

nothing to give them relief on their subsequently assenting the asset to a legatee. (Section 62(4)(b) TCGA states that the *legatee* shall be treated as if the PRs acquisition had been his. It makes no comment about the position of the PRs. The approach of the House of Lords in *R v Dimsey & Allen* was that relief in this situation should not be implied.)

(2) Another problem would arise if the PRs receive a dividend from the company, before distributing the shares to a legatee. The legatee would receive the shares but may not receive any funds representing the gain so it would not be fair that the company gain should be treated as accruing to him. The relief under s.13(5A) TCGA would not work properly.

(3) There would be an anomalous distinction between:
   (a) an assent of the shares (s.13 applies to the legatee); and
   (b) sale (or liquidation) of the company and assent of the proceeds to the legatee (s.13 TCGA does not apply).

For these reasons it is suggested that the deeming of s.62(4)(b) TCGA does not extend to deem the legatee to receive the company gains under s.13. This construction is also consistent with the limited view of the deeming provision taken in *Marshall* v *Kerr* 67 TC 56.

56.7 Deceased UK resident

If the deceased was UK resident and domiciled, the PRs are UK resident and domiciled, and so subject to CGT on all chargeable gains (less losses).

56.7.1 *Deceased UK resident not UK domiciled*

Suppose at the time of his death the deceased was UK resident but foreign domiciled. The PRs are treated as UK resident but not UK domiciled. CG Manual para 30660 provides:

> **Remittance basis not in administration period** Published 7/94
> If the deceased was resident and/or ordinarily resident but not domiciled in the UK before his or her death, then on disposing of assets outside the UK he or she would have benefited from the application of the remittance basis in Section 12 TCGA ... . Although the PRs have the same residence and domicile status as the deceased had, if they realise chargeable gains from disposals of assets situated outside the UK but do

not remit those gains to the UK immediately they cannot benefit from this treatment. This is because the remittance basis applies only to individuals but Section 65(2) says that the body of PRs is not to be treated as an individual.

This remains valid after the 2008 reforms. At first sight this seems surprising, but on reflection, it is not absurd to draw a distinction between:

(1) a UK resident foreign domiciled individual, taxed on the remittance basis, and
(2) the PRs of that individual, taxed on an arising basis.

A remittance basis makes less sense for PRs whose role is generally short term.[13]
Of course, if the PRs are actually outside the UK, especially if they are outside the EU, HMRC may not, in practice, be able to recover the tax.
DTR is available to treaty non-resident PRs which may solve this problem.

56.8 CGT planning for UK resident PRs

If PRs sell assets in the course of administration, then any gain will be subject to CGT, even though the net proceeds of sale will in due course pass to a remittance basis taxpayer. If, by contrast, PRs transfer an asset *in specie* to a legatee to whom it has been bequeathed, whether specifically or as part of residue, then the PRs will not realise any chargeable gain but the base cost of the recipient beneficiary will be that of the PRs.[14] Where the legatee is a remittance basis taxpayer (or a non-UK resident, or a charity), he will often be able to dispose of the asset in due course free of CGT.

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13 It has been argued that the HMRC view is wrong. The argument was largely based on a supposed anomalous position of PRs. Following the 2008 reforms, the anomalies work the other way (for if the remittance basis applied, it would be anomalous that PRs did not pay the £30k remittance basis charge). The argument would require the word "individual" in s.12(1) TCGA to be construed so as to include PRs, which is quite contrary to general statutory usage. So I do not think the argument now merits serious attention (but readers can find further discussion in the 2008/09 edition of this work.)

14 See 52.2.2 (Transfers from PRs to beneficiaries)

It is thus a fundamental principle of CGT planning that PRs should generally avoid, wherever possible, making disposals of assets which pass under the will to remittance basis taxpayers, non-residents or charities, if a gain (less losses) arises on the disposal.

Suppose that a remittance basis taxpayer is entitled to a pecuniary legacy of £1,000,000 under a will. The estate holds a foreign situate asset which had a value of £600,000 at the date of the death of the deceased and which is now worth £1,000,000. If the PRs sell the asset in order to pay the legacy, they will be liable to CGT. This liability can be avoided by the PRs agreeing to transfer the property to the legatee in satisfaction of his pecuniary legacy.

Suppose the PRs inherit an asset belonging to the deceased which is the subject matter of a specific gift in his will; that they then sell the asset, the sale giving rise to a charge to CGT, and that they subsequently transfer the whole or part of the proceeds of sale to the specific legatee. The common law doctrine of relation back does not apply here. This doctrine would appear to operate only where an asset owned by the deceased is subsequently vested in the legatee. In any case, the express provisions of the statutory code deal so comprehensively with the situation that any application of the doctrine of relation back to CGT is by necessary implication excluded. So if there is such a sale, the PRs bear the CGT and transferring the proceeds of sale to the remittance basis taxpayer does not confer any exemption.

It may be necessary to sell some assets to pay liabilities of the PRs, and it may be that the assets available for sale will give rise to a chargeable gain.

One solution is as follows:

(1) The PRs assent the asset to the beneficiary subject to a charge for their liabilities under s.36(10) Administration of Estates Act 1925.
(2) The beneficiary then sells the asset: any gain on the sale accrues to the beneficiary: s.26(2) TCGA.
(3) Under the charge the proceeds are used to pay the PRs' liability.

56.9 CGT planning by IoV

Where there is more than one residuary legatee and some are remittance basis taxpayers, non-residents or charities, it would often make sense for assets with inherent capital gains to be transferred to them rather than to

UK resident and domiciled individuals. This can often be done by means of an appropriation under s.41 Administration of Estates Act 1925, but (depending on the terms of the will) an instrument of variation may be necessary. The variation must be made within two years of the death of the deceased.

The basic strategy should be to redirect foreign assets of the estate with inherent capital gains to the remittance basis taxpayer. UK resident and domiciled beneficiaries would instead receive cash or assets without inherent gains. The remittance basis taxpayer might in due course realise the gains free of tax. There would be an overall tax saving, which could be shared between the remittance basis taxpayer and the other beneficiaries by negotiation, or which could be allowed to accrue entirely to the remittance basis taxpayer if the other beneficiaries were so minded.

CHAPTER FIFTY SEVEN

ESTATES OF DECEASED PERSONS: INCOME TAX

57.1 Meaning of "PRs" for income tax

This chapter considers the income taxation of "PRs" and of beneficiaries of estates of deceased persons.

Section 989 ITA provides a commonsense definition of PRs:

> The following definitions apply for the purposes of the Income Tax Acts—
> "personal representatives" in relation to a person who has died, means—
> (a) in the UK, persons responsible for administering the estate of the deceased, and
> (b) in a territory outside the UK, those persons having functions under its law equivalent to those of administering the estate of the deceased.

There is no rule that PRs are a single and continuing body of persons separate from the persons who are actually the PRs. This is anomalous (for such a rule applies for to PRs for CGT and applies to trustees for both taxes. However it will not often matter.

57.2 Residence of PRs for income tax

PRs are UK resident for income tax if they are all UK resident in their personal capacity. They are non-resident if they are all non-resident in their personal capacity. The position where an estate has both resident and non-resident PRs is governed by s.834 ITA:

> **834 Residence of personal representatives**
> (1) This section applies for income tax purposes if the personal

> representatives of a deceased person ("D") include one or more persons who are UK resident and one or more persons who are non-UK resident.
> (2) If the following condition is met, the person or persons who are non-UK resident are treated, in their capacity as personal representatives, as UK resident.
> (3) The condition is that when D died D was UK resident, ordinarily UK resident or domiciled in the UK.
> (4) If that condition is not met, the person or persons who are UK resident are treated, in their capacity as personal representatives, as non-UK resident.

Thus it is possible to arrange that PRs are not UK resident for income tax purposes. All of the PRs must be non-resident in their private capacities, (except in the case of a non-resident, non-ordinarily resident, non-domiciled testator where only one PR need be non-resident).

57.3 Income taxation of PRs

PRs are "persons" and so pay income tax at the ordinary rate (i.e. basic or dividend ordinary rate) on the income of the estate if:

(1) the PRs are UK resident, or
(2) the income has a UK source.

57.4 Income from specific legacy

If the PRs assent to the asset and its income vesting in the beneficiary, something rather peculiar happens. The beneficiary is deemed to have been the owner of the asset since the death. This rule – the doctrine of relation back – operates for income tax purposes: *IRC v Hawley* 13 TC 327. Thus, the beneficiary will, retrospectively, be treated as having received the income year by year as it arose and the PRs will be treated as if they had not received it. The PRs may have paid UK tax. This will retrospectively be treated as being paid by the PRs on behalf of the beneficiary. Thus a beneficiary who is a remittance basis taxpayer can reclaim tax paid by UK resident PRs on unremitted foreign income. A non-resident beneficiary can also reclaim tax (it is not necessary to rely on ESC A14).

TSE Manual provides at 7490 [January 2008]:

Tax rules for specific legacies.

A legacy may take the form of an asset that does not produce income – for example a picture or a piece of jewellery. The beneficiary does not receive income and has no tax liability in respect of the legacy.

Other assets can produce income – for example a bank account, shareholding or land. The general rule is that the beneficiary is entitled to the income arising to that asset from the death of the deceased person. Sometimes however the personal representatives may by law be entitled to use the income for some other purpose.

If the beneficiary gets the income it should be treated as his income for the year in which it arises. The authority for this is *IRC v Hawley* 13 TC 327. The beneficiary cannot however be taxed on or given repayment on income that he did not receive.

57.5 Income from residuary estate

In order to appreciate the law it is helpful to understand its history. In *R v Special Commissioners, ex p. Dr Barnado's Homes* 7 TC 646, the residuary legatee was a charity. Income arose to the PRs during the period of administration on which the PRs paid income tax. The residuary legatee was not entitled to the income of the residuary estate as it arose during the period of administration, so it could not at that time reclaim income tax paid. Instead it sought to recover the tax when it actually received the income, on completion of administration. The House of Lords held that although the sum received by the charity represented (or was derived from) the PR's income, it was received by the charity as a capital receipt (like accumulated income of a trust). The payment on the completion of administration did not confer retrospective title on the residuary legatee to such income as income. So income tax paid by the PRs could never be recovered by the charity. The doctrine of relation back was not extended to gifts of residue. That was a victory for HMRC, who were no doubt unperturbed about the unfairness to the charity. But subsequently, predictably, individual residuary legatees successfully contended that they were not liable to super-tax (which became surtax in 1927 and is now higher rate tax) on the income of a residuary estate arising during the administration period.[1] HMRC then realised they had made a rod for their own backs. Legislation was therefore brought in which is now to be found

1 e.g. *Corbett v IRC* 21 TC 449. There are several income tax cases on the issue of whether administration was completed.

in Chapter 6 Part 5 ITTOIA. A full discussion needs a book to itself. I do not consider the equivalent provisions applicable for corporation tax which would apply to UK corporate beneficiaries.

57.6 Absolute/limited/discretionary interest in residue

The legislation distinguishes absolute/limited/discretionary interests in residue.

Section 650 ITTOIA provides fairly commonsense definitions of these terms:

> (1) A person has an absolute interest in the whole or part of the residue of an estate for the purposes of this Chapter if—
> (a) the capital of the residue or that part is properly payable to the person, or
> (b) it would be so payable, if the residue had been ascertained.
> (2) A person has a limited interest in the whole or part of the residue of an estate during any period for the purposes of this Chapter if—
> (a) the person does not have an absolute interest in it, and
> (b) the income from it would be properly payable to the person if the residue had been ascertained at the beginning of that period.

In practice the usual example of a limited interest is a life interest.

> (3) A person has a discretionary interest in the whole or part of the residue of an estate for the purposes of this Chapter if—
> (a) a discretion may be exercised in the person's favour, and
> (b) on its exercise in the person's favour any of the income of the residue during the whole or part of the administration period (see section 653) would be properly payable to the person if the residue had been ascertained at the beginning of that period.

Section 650(4) (6) ITTOIA defines "properly payable" and s. 650(5) deals with the situation where PRs have an interest in another estate.

57.7 "UK estate" and "foreign estate"

The legislation distinguishes between a "UK estate" and a "foreign estate". The distinction matters for two purposes:

(1) Computation of the basic amount.
(2) Source of income (relevant to remittance basis taxpayers).

These terms are defined in s.651(1) ITTOIA:

> "UK estate", in relation to a tax year, means an estate[2] which meets conditions A and B, or condition C, for that year, and
> "foreign estate", in relation to a tax year, means an estate which is not a UK estate in relation to that year.

I refer below to **"UK estate conditions"** A to C to distinguish them from the myriad other conditions in ITTOIA. Unfortunately these conditions are in a tangle. An estate may be a UK estate in one year and a foreign estate in another year. The question must be addressed each year.

57.7.1 *UK estate conditions A and B*

Section 651 ITTOIA provides:

> (2) Condition A is that all the income of the estate either—
> (a) has borne UK income tax by deduction, or
> (b) is income in respect of which the personal representatives are directly assessable to UK income tax for the tax year.
> (3) Condition B is that none of the income of the estate is income for which the personal representatives are not liable to UK income tax for the tax year because they are not UK resident or not ordinarily UK resident.

If the PRs are UK resident, condition A is satisfied (they are directly assessable to IT) and condition B is satisfied[3] so the estate is a UK estate.

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2 Section 649(2) ITTOIA provides a commonsense definition of "estate":
In this Chapter—
"estate" means the estate of a deceased person (whether a UK estate or a foreign estate).

3 It takes more than one reading to comprehend the triple negative in condition B (the source legislation was clearer before the ITTOIA rewrite). Suppose PRs are not UK resident and receive foreign source income. The position is that condition B is not satisfied because:
(1) The PRs are not liable to IT on that income
(2) The reason they are not liable is that they are not UK resident: had they been UK resident, they would have been liable.

If the PRs are non-resident, and have some foreign source income:
(a) condition A is not satisfied (some of their income is not taxable)
(b) it does not matter whether condition B is satisfied
so the estate is a UK estate.

If the PRs are non-resident but have only UK source taxable income, condition A is satisfied (they are assessable) and condition B is satisfied (no foreign income) so the estate is a UK estate.

If the PRs are non resident and have some UK income which qualifies for exemption (eg gilts) the estate is a foreign estate.

It is easy to procure that an estate with non-resident PRs qualifies as a "foreign estate" by arranging that there is some foreign income.

57.7.2 *Disregarded income*

Section 651(4) ITTOIA provides:

> For the purposes of conditions A and B sums within section 680(3) or (4) (sums treated as bearing tax) are ignored.

The list of disregards in s.680 ITTOIA is as follows:

> (3) The following sums are treated as bearing income tax at the dividend ordinary rate—
> (a) a sum charged under Chapter 3 of Part 4 (dividends etc. from UK resident companies etc.), or
> (b) a sum that is part of the aggregate income of the estate because of falling within—
> (i) section 664(2)(c) (stock dividends), or
> (ii) section 664(2)(d) (release of loan to participator in close company where debt due from personal representatives).
> (4) A sum that is part of the aggregate income of the estate because of falling within section 664(2)(e) (gains from life insurance contracts etc) is treated as bearing income tax at the basic rate.

It is convenient to have a term to describe these categories of income, so

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(3) Thus it is not the case that "none of the income of the estate is income for which the personal representatives are not liable to UK income tax for the tax year because they are not UK resident".
The same applies if non ordinarily resident PRs receive income from exempt gilts.

I call it **"disregarded income"**.
Why is this income disregarded? Prior to 1996, s.233(1) ICTA 1988 (repealed) provided:

> *Where in any year of assessment the income of any person, not being a company resident in the UK, includes a distribution in respect of which that person is not entitled to a tax credit*
> *(a) no assessment shall be made on that person in respect of income tax at the basic rate on the amount or value of the distribution ...*

Thus non-resident PRs who received dividend income would not be assessable and so would count as a foreign estate.
Section 651(5) ITTOIA provides:

> Condition C is that the aggregate income of the estate for the tax year consists only of sums within section 680(3) or (4).

57.8 Payment

The legislation uses the word "payment" but (like capital payment for s.87) this is widely defined. Section 681 ITTOIA provides:

> (1) For the purposes of this Chapter—
> (a) a transfer of assets, or
> (b) the appropriation of assets by personal representatives to themselves,
> is treated as the payment of an amount equal to the assets' value at the date of transfer or appropriation.
> (2) The set off or release of a debt is treated for the purposes of this Chapter as the payment of an amount equal to it.
> (3) If at the end of the administration period—
> (a) there is an obligation to transfer assets to any person, or
> (b) personal representatives are entitled to appropriate assets to themselves,
> an amount equal to the assets' value at that time is treated as payable then for the purposes of this Chapter.
> (4) If at the end of the administration period—
> (a) there is an obligation to release or set off a debt owed by any person, or
> (b) personal representatives are entitled to release or set off a debt in their own favour,

a sum equal to the debt is treated as payable then for the purposes of this Chapter.

57.9 Charge on estate income

There are essentially three parts to the legislation:
(1) The charge to tax on estate income.
(2) The definition of when estate income arises.
(3) The quantification of the amount of estate income.

Section 649(1) ITTOIA provides the charge to tax:

> Income tax is charged on estate income.

57.10 Estate income

Estate income is label which brings in different rules for the different types of interest in residue. Section 649(2) ITTOIA provides a referential definition:

> (2) In this Chapter—
> "estate income" means the income treated under this Chapter as arising from an absolute, limited or discretionary interest in the whole or part of the residue of an estate ...
> (3) Estate income is treated as income for income tax purposes.
> (4) If different parts of an estate are subject to different residuary dispositions, those parts are treated for the purposes of this Chapter as if they were separate estates.

The circumstances in which estate income is treated as arising depend on the type of interest in residue. These are set out in ss.652–655 ITTOIA. These provisions state *when* estate income is treated as arising. The question of the *amount* of estate income is addressed separately.

57.10.1 *When estate income arises: absolute interest in residue*

Section 652 ITTOIA provides:

> (1) Income is treated as arising in a tax year from a person's absolute interest in the whole or part of the residue of an estate if—

> (a) the person has an assumed income entitlement for the tax year in respect of the interest (see sections 665 to 670), and
> (b) condition A or B is met.
>
> (2) Condition A is that a payment is made in respect of the interest in the tax year and before the end of the administration period (see section 653).
> (3) Condition B is that the tax year is the final tax year (see section 653).
> (4) Income treated as arising as a result of this section is estate income for the purposes of this Chapter.

The key term here is "assumed income entitlement" which is discussed below.

For completeness, s.653 ITTOIA provides commonsense definitions of "administration period" and "final tax year":

> (1) In this Chapter "the administration period", in relation to the estate of a deceased person, means the period beginning with the deceased's death and ending with the completion of the administration of the estate.
> (2) In the application of subsection (1) to Scotland, the reference to the completion of the administration is to be taken as a reference to the date at which, after discharge of, or provision for, liabilities falling to be met out of the deceased's estate, the free balance held in trust for the residuary legatees or for the persons with the right to the intestate estate has been ascertained.
> (3) In this Chapter "the final tax year" means the tax year in which the administration period ends.

57.10.2 *When estate income arises: limited interest in residue*

Section 654 ITTOIA provides:

> (1) Income is treated as arising in a tax year from a person's limited interest in the whole or part of the residue of an estate in cases A, B and C.
> (2) Case A is where—
> (a) the interest has not ceased before the beginning of the tax year, and
> (b) a sum is paid in respect of the interest in that year and before the end of the administration period.
>
> (3) Case B is where—
> (a) the tax year is the final tax year,
> (b) the interest has not ceased before the beginning of that year,

and

(c) a sum remains payable in respect of the interest at the end of the administration period.

(4) Case C is where—

(a) the tax year is a year before the final tax year,

(b) the interest ceases in the tax year, and

(c) a sum is paid in respect of the interest in a later tax year but before the end of the administration period, or remains payable in respect of it at the end of that period. ...

(6) Income treated as arising as a result of this section or section 674 is estate income for the purposes of this Chapter.

57.10.3 *When estate income arises: discretionary interest in residue*

Section 655 ITTOIA provides:

> (1) Income is treated as arising in a tax year from a person's discretionary interest in the whole or part of the residue of an estate if a payment is made in the tax year in exercise of the discretion in that person's favour.
> (2) Income treated as arising as a result of this section is estate income for the purposes of this Chapter.

57.11 Amount of estate income

There are two aspects to the rules: quantifying the "basic amount", and grossing up.

57.11.1 *UK estate*

Section 656 ITTOIA provides:

> **656 Income charged: UK estates**
> (1) In the case of a UK estate, tax is charged under section 649 on the amount of estate income treated as arising in the tax year.

Section 656 defines this as follows:

> (2) That amount is the basic amount of that income for the tax year (see subsection (4)) grossed up by reference to the applicable rate for that year (see section 663).

> (3) The gross amount is treated as having borne income tax at that rate.

The applicable rate is not discussed here. The key term is the "basic amount" of estate income. Section 656(4) provides four referential definitions.

> In this Chapter "the basic amount", in relation to estate income, has the meaning given by—
> (a) section 660 (basic amount of estate income: absolute interests),
> (b) section 661 (basic amount of estate income: limited interests),
> (c) section 662 (basic amount of estate income: discretionary interests), and
> (d) section 675 (basic amount of estate income: successive limited interests).

57.11.2 *Foreign estate*

Section 657(1) ITTOIA provides:

> In the case of a foreign estate, tax is charged under section 649 on the full[4] amount of estate income treated as arising in the tax year.

The section goes on to specify the amount:

> (2) That amount depends on whether the estate income arising in the tax year is paid from sums within section 680(3) or (4) (sums treated as bearing income tax).
> (3) So far as the estate income is paid from such sums, that amount is the basic amount of that income for the tax year grossed up by reference to the applicable rate for that year (see section 663).
> (4) That gross amount is treated as having borne income tax at that rate.
> (5) So far as the estate income is not paid from sums within section 680(3) or (4), the amount of estate income treated as arising in the tax year is the basic amount of that income for that year.

The difference between UK and foreign estates is that in the latter case there is no grossing up.

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4 Section 657 refers to the "full amount" and s.656 refers only to the "amount", but the word "full" is clearly otiose: there is no difference in meaning.

57.12 Person liable

Section 659 identifies the person liable:

> (1) If the estate income is from a person's absolute interest or limited interest, that person is liable for any tax charged under section 649 unless subsection (3) or (4) provides that another person is liable.
> (2) If the estate income is from a discretionary interest, the person in whose favour the discretion is exercised in making the payment in question is liable for any tax charged under section 649.

That seems self-evident. Subsection (3)(4) (not set out here) deal with successive interests. We turn at last to the key concept "basic amount".

57.13 "Basic amount of estate income"

The quantum of the"basic amount of estate income" depends on the type of interest in residue, ie whether there is an absolute, limited or discretionary interest.

57.13.1 *Basic amount of estate income: absolute interest*

Section 660 ITTOIA provides:

> **660 Basic amount of estate income: absolute interests**
> (1) The basic amount of estate income relating to a person's absolute interest in the whole or part of the residue of an estate for a tax year before the final tax year is the lower of—
> (a) the total of all sums paid in the tax year in respect of that interest, and
> (b) the amount of the person's assumed income entitlement for the tax year in respect of it.
> (2) The basic amount for the final tax year is equal to the amount of the person's assumed income entitlement for that year in respect of that interest.

The next key term is "assumed income entitlement".

57.13.2 *Basic amount of estate income: limited interest*

Section 661(1) ITTOIA provides:

> **661 Basic amount of estate income: limited interests**
> (1) The basic amount of estate income relating to a person's limited interest in the whole or part of the residue of an estate for a tax year is the total of the sums within section 654(2)(b), (3)(c) and (4)(c) for that year.

57.13.3 *Basic amount of estate income: discretionary interest*

Section 662 ITTOIA provides:

> **662 Basic amount of estate income: discretionary interests**
> The basic amount of estate income relating to a person's discretionary interest in the whole or part of the residue of an estate for a tax year is the total of the payments made in the tax year in exercise of the discretion in favour of the person.

57.13.4 *HMRC practice*

This is too complicated and in practice no-one takes much notice of it. The TSEM provides:

> **7654. Payments made during the administration period** [January 2008]
> ... ***The statutory basis***
> The statutory basis is provided in Sections 654, 656 and 661 ITTOIA. This requires all sums paid during or payable on completion of the administration period to be spread evenly throughout the years (and part years) of assessment covered by the administration period. The amounts allocated to each year are then deemed to be the net income of the beneficiary for that year. The amount concerned is grossed at the applicable rate. This is the basic rate or the savings rate depending on the sources of the underlying income.
> You may have received a report from HMRC Trusts Edinburgh in respect of a limited interest in residue where the administration was completed before 6 April 1995. It will have been prepared on the basis set out in the previous paragraph. It is unlikely that you will come across other cases where it is worthwhile insisting on the statutory basis. If the

beneficiary asks for the statutory basis to be applied, you should ask for a computation on that basis. If you have any problems with such a computation ask HMRC Trusts Edinburgh for advice.

The conventional basis

The beneficiary is treated as if he had been entitled to the income of the estate (or an appropriate part of the estate) as and when the income arose to the personal representatives. The basis applies for all purposes including repayments.

57.14 Assumed income entitlement

The key term "assumed income entitlement" is relevant to computation of the basic amount. For absolute interests, this is (in brief) calculated as follows.

First one calculates the "aggregate income of the estate". This has a broadly commonsense definition in s.664 ITTOIA:

664 The aggregate income of the estate

(1) For the purposes of this Chapter the aggregate income of the estate for a tax year is

[a] the total of the income and amounts specified in subsection (2), but

[b] excluding the income specified in subsection (5).

(2) The income and amounts are—

- (a) the income of the deceased's personal representatives in that capacity which is charged to UK income tax for the tax year,
- (b) the income of the deceased's personal representatives in that capacity on which such tax would have been charged for the tax year if—
  - (i) it was income of a UK resident who was ordinarily UK resident, and
  - (ii) it was income from a source in the UK,[5]
- (c) any amount of income treated as arising to the personal representatives under section 410(4) (stock dividends) that would be charged to income tax under Chapter 5 of Part 4 if income arising to personal representatives were so charged (see section 411),
- (d) in a case where section 419(2) applies (release of loans to participator in close company: loans and advances to persons

5 I cannot see the point in (ii). If it is income of a UK resident, why does the source matter?

who die), the amount that would be charged to income tax under Chapter 6 of Part 4 apart from that section, and

(e) any amount that would have been treated as income of the personal representatives in that capacity under section 466 if the condition in section 466(2) had been met (gains from contracts for life insurance).

(3) In calculating the amount of the income within subsection (2)(a), any allowable deductions are to be taken into account.

(4) In calculating the amount of the income within subsection (2)(b), any deductions which would be allowable if the income had been charged to UK income tax are to be deducted from the full amount of the income actually arising in the tax year.

Section 664(5) deals with deductions:

> The excluded income is—
>
> (a) income to which any person is or may become entitled under a specific disposition[6], and
>
> (b) income from property devolving on the personal representatives otherwise than as assets for payment of the deceased's debts.

Armed with the figure for the aggregate income of the estate, one next computes "the residuary income of the estate". This brings in rules for allowable deductions. Section 666 ITTOIA provides:

> (1) For the purposes of this Chapter the residuary income of an estate for a tax year is
>
> [1] the aggregate income of the estate for that year, less
>
> [2] the allowable estate deductions for that year.
>
> This is subject to section 669 (reduction in residuary income: inheritance tax on accrued income).
>
> (2) The allowable estate deductions for a tax year are—

6 Defined in subsection (6): "In subsection (5)(a) 'specific disposition' means a gift of specific property under a will, including—
(a) the disposition of personal chattels by section 46 of the Administration of Estates Act 1925 (c 23) (succession on intestacy), and
(b) any disposition which under the law of another country has a similar effect to a gift of specific property by will under the law of England and Wales,
but excluding real property included in a residuary gift made by will by a specific or general description of it or, in Scotland, heritable estate included in such a gift."

(a) all interest paid in that year by the personal representatives in that capacity (but see section 233 of IHTA 1984: exclusion of interest on unpaid inheritance tax),
(b) all annual payments for that year which are properly payable out of residue,
(c) all payments made in that year in respect of expenses incurred by the personal representatives in that capacity in the management of the assets of the estate, and
(d) any excess deductions from the previous tax year.[7]

This is subject to subsections (3) to (5).
(3) No sum is to be treated as an allowable estate deduction if it is allowable in calculating the aggregate income of the estate.
(4) No sum is to be counted twice as an allowable estate deduction.
(5) Payments in respect of expenses are only allowable estate deductions if they are properly chargeable to income (ignoring any specific direction in a will).

In short, one deducts "allowable estate deductions" to obtain the "residuary income of the estate."

Armed with the figure for the residuary income of the estate, we are at last in a position to compute the assumed income entitlement. Section 665 ITTOIA provides:

665 Assumed income entitlement
(1) Whether a person has an assumed income entitlement for a tax year in respect of an absolute interest in the whole or part of the residue of an estate depends on the results of the following steps.
Step 1 Find the amount of the person's share of the residuary income of the estate that is attributable to that interest for that tax year and each previous tax year during which the person had that interest (see sections 666 to 669).
Step 2 If the estate is a UK estate in relation to any tax year for which an amount has been found under step 1, deduct from that amount income tax on that amount at the applicable rate for that year (see section 670).
Step 3 Add together the amounts found under step 1 after making any deductions necessary under step 2.

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7 This is defined in s.666(6):
"In this section 'excess deductions from the previous tax year' means so much of the allowable deductions for the previous tax year as exceeded the aggregate income of the estate for that year."

Step 4 Add together the basic amounts relating to the person's absolute interest in respect of which the person was liable for income tax for all previous tax years (or would have been so liable if the person had been a person liable for income tax for those years).
(2) For the purposes of this Chapter the person has an assumed income entitlement for the tax year if the amount resulting from step 3 exceeds the amount resulting from step 4.
(3) The assumed income entitlement is equal to the excess.
(4) [This deals with successive interests].

57.15 Beneficiary a remittance basis taxpayer

Section 658 ITTOIA brings in the remittance basis:

658 Special rules for foreign income
(1) The charge to tax under section 649 on the amount of income arising in a tax year is subject to Part 8 (foreign income: special rules).
(2) For the purposes of section 830(1) (meaning of "relevant foreign income") amounts charged to tax under section 649—
(a) are treated as arising from a source outside the UK if the estate is a foreign estate, and
(b) are treated as not arising from such a source if the estate is a UK estate.

The section uses the words "treated as" because the income (being fictional income) does not have a source.[8]

If a beneficiary is a remittance basis taxpayer, it is important to ensure that the estate is a "foreign estate" and not a "UK estate" because the remittance basis only applies to a foreign estate.

Since the estate income is deemed income, not real income, it cannot be remitted. There is no rule that the PRs income or the beneficiary's actual receipts are is deemed to be derived from the estate income.

57.16 Non-resident beneficiary

57.16.1 *Non-resident beneficiary of UK estate*

ESC A14 provides:

8 See 11.4.1 (Location of source of income when there is no source).

A14 Deceased person's estate: residuary income received during the administration period

A beneficiary who for a year of assessment is not resident or not ordinarily resident in the UK, and is deemed under ITTOIA ss.657, and 830(1) to have received income from a UK estate in that year, may claim to have their tax liability on that income from the estate adjusted to what it would be if such income had arisen to them directly and as a result they—

- could claim relief under TA 1988 s.278 (claim to personal reliefs by certain non residents); or
- could claim entitlement to exemption in respect of FOTRA Securities issued in accordance with ITTOIA s.714; or
- could claim relief under the terms of a double taxation agreement; or
- would not have been chargeable to income tax.

Relief or exemption, as appropriate, will be granted to the beneficiary only if the personal representatives of the estate—

- have made estate returns for each and every year for which they are required, and
- have paid all tax due and any interest, surcharges and penalties arising, and
- keep available for inspection any relevant tax certificates, together with copies of the estate accounts for all years of the period of administration showing details of all sources of estate income and payments made to beneficiaries.

Relief or exemption, as appropriate, will be granted to the beneficiary on a claim made within five years and ten months of the end of the year of assessment in which the beneficiary is deemed to have received the income.

No tax will be repayable to the beneficiary in respect of income they are deemed to have received where the basic amount of estate income, if received by a UK resident beneficiary of an estate, is paid sums within ss.657(3), (4) and 680(3), (4) ITTOIA.

57.16.2 *Non-resident beneficiary of foreign estate*

Section 577 ITTOIA provides the necessary exemption to the charge on estate income:

577 Territorial scope of Part 5 charges

(1) Income arising to a UK resident is chargeable to tax under this Part whether or not it is from a source in the UK.

(2) Income arising to a non-UK resident is chargeable to tax under this Part only if it is from a source in the UK.
(3) References in this section to income which is from a source in the UK include, in the case of any income which does not have a source, references to income which has a comparable connection to the UK.
(4) This section is subject to any express or implied provision to the contrary in this Part (or elsewhere in the Income Tax Acts).

CHAPTER FIFTY EIGHT

WHO IS THE SETTLOR?

58.1 Why does it matter who is the settlor?

The identity of the settlor of a settlement is relevant for many tax purposes. It is not practical to compile a full list, but the rules mostly fall into four classes:

(1) Rules taxing a settlor on trust income and gains.[1]
(2) Rules taxing trustees (or beneficiaries) if the settlor is UK domiciled or resident. The tax status of the settlor is an appropriate connecting factor for the taxation of the trustees or the beneficiaries. The most important example is the IHT excluded property rule.[2] So the question of the identity of the settlor often arises in matters concerning foreign domiciliaries.
(3) Connected person rules, which apply if a person is connected with the settlor.
(4) Reverter to settlor rules.[3]

The identity of the settlor is also relevant for trust law purposes (e.g. the rule against accumulations may restrict accumulation to life of settlor).

The person named as "the settlor" in the trust document is not necessarily a settlor, or the only settlor, for tax purposes.[4]

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1 See 16.1 (Settlor-interested trusts) and 37.2 (Fundamental s.86 conditions).

2 See 44.1 (Excluded property for IHT).

3 See s.54 IHTA.

4 On nominal settlors see *Drafting Trusts and Will Trusts*, James Kessler QC, 8th ed. para 10.14.

58.2 Definitions of "settlement"

Before discussing "settlor" we need to discuss "settlement".

For most purposes the words "settlement" and "trust" are interchangeable,[5] though when referring to statutory provisions it is clearer to use the statutory terminology.

58.2.1 *Terminology*

We need labels for the three different definitions, and I use the following terms:

(1) *Classic settlements*

(a) ***Standard IT/CGT definition of "settlement"***
This definition applies in the Income Tax Acts and TCGA unless the context otherwise requires. In some cases the context does "otherwise require" because the settlement-arrangement definition is applied. I cannot think of any other case where the context would "otherwise require".

(b) ***IHT definition***: the definition for the purposes of IHT.
For the present purposes (identifying the settlor) the IHT definition is effectively the same as the standard IT/CGT definition, there is no need to distinguish between them.

I use the term "**classic settlement**" to describe a trust which is a settlement within the standard IT/CGT and IHT definitions.[6]

(2) ***Settlement-arrangement***
This is the definition which applies for the purposes of the IT settlement provisions. It is also applied in various other contexts. In earlier editions I called this *the* IT definition but that terminology is inappropriate following the introduction of the standard IT/CGT definition in 2006; also the settlement-arrangement definition is adopted for several purposes for CGT. In the 6th edition I called this "the broad definition" but I think "settlement-arrangement" is the clearest term.

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5 See *Drafting Trusts and Will Trusts*, James Kessler, 8th ed., p. xxxiv (Terminology).

6 This terminology is from Lord Walker's speech in *Jones v Garnett* [2007] STC 1536.

Equipped with this terminology we can now consider the various definitions of "settlement".

58.2.2 *Standard IT/CGT definition of "settlement"*

Section 466 ITA provides:

> **466 Meaning of "settled property" etc**
> (1) This section applies for the purposes of the Income Tax Acts, except so far as, in those Acts, the context otherwise requires.
> (2) "Settled property" means any property held in trust other than property excluded by subsection (3).
> (3) Property is excluded for the purposes of subsection (2) if—
> (a) it is held by a person as nominee for another person,
> (b) it is held by a person as trustee for another person who is absolutely entitled[7] to the property as against the trustee, or
> (c) it is held by a person as trustee for another person who would be absolutely entitled to the property as against the trustee if that other person were not an infant or otherwise lacking legal capacity.
> (4) References, however expressed, to property comprised in a settlement are references to settled property.[8]

This is strictly a definition of "settled property" not "settlement" but, as subs.(4) illustrates, the cognate expression is used with the same meaning.

58.2.3 *Settlement-arrangement*

Section 620(1) ITTOIA provides:

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7 These terms are defined in s.466(5)(6) ITA:
"(5) A person is absolutely entitled to property as against a trustee if the person has the exclusive right to direct how the property is to be dealt with (subject to the trustees' right to use the property for the payment of duty, taxes, costs or other outgoings).
(6) References to a person who is or would be so entitled include references to two or more persons who are or would be jointly absolutely entitled as against the trustee."

8 The legislation is set out in full in ITA and TCGA, but there are no significant differences, so I give the text of ITA only. The CGT equivalent is in ss.60, 68 TCGA 1992.

> In this Chapter "settlement" includes[9] any disposition, trust, covenant, agreement, arrangement or transfer of assets....

In *Jones v Garnett*, Lord Hoffmann explains:

> Not every transfer of property is a settlement for the purposes of [the settlement-arrangement definition]. There has to be an "element of bounty" in the transaction. This old-fashioned phrase, apparently derived from the judgment of Plowman J in *IRC v Leiner* 41 TC 589 and approved by the House of Lords in *IRC v Plummer* [1980] AC 896, conjuring up the image of Lady Bountiful in *The Beaux' Stratagem*, is perhaps not the happiest way of describing a provision for a spouse or minor children. ... It is nevertheless exactly the kind of thing at which the anti-avoidance provisions are aimed. In *Chinn v Hochstrasser* [1981] AC 533 Lord Roskill cautioned against treating the word "bounty" as if it had been included in the statute. It seems to me that the general effect of the cases is that, under the arrangement, the settlor must provide a benefit which would not have been provided in a transaction at arms' length.[10]

The term "bounty" was criticised by Lady Hale in the same case, but it is likely to continue in use as a technical term. It is short, accurate, and memorable if archaic.[11]

The bounty requirement is not quite the same as a "commercial" requirement, but the concepts overlap. In IRC v Levy , the judge noted that "a commercial transaction devoid of any element of bounty is not within

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9 The context shows this is an exhaustive definition, i.e. the word "includes" really means "means".

10 [2007] STC 1536 at [7]. HMRC accept this. TSE Manual para 4110:

> "**4110. Restrictions to the definition of settlement**
> A purely commercial transaction at arms length is outside the meaning of 'settlement'.
> Settlement must include an element of bounty, as decided in the tax case of *IRC v Plummer* (54 TC 1). Bounty is the provision of value without any corresponding quid pro quo, usually a gift or a transfer at less than full value."

11 Lord Neuberger agrees in *Jones v Garnett* [2007] STC 1536 at [76]:

> "The word 'bounty' rings slightly uncomfortably, at least to my ears. ... However, in the light of the judicial decisions on these provisions, it seems to me that the law is now tolerably clear and sensible, and, particularly given the need for clarity and the room for difficulties in this area, it would be inappropriate to risk introducing uncertainty or new complications by redefining the principles, even if only linguistically."

the definition". In that case an interest free loan to a company wholly owned by the lender was held to be a *simple case of a commercial transaction devoid of any element of bounty* and hence not a settlement-arrangement.[12]

By contrast, the standard IT/CGT and IHT definitions of "settlement" do not include a bounty requirement.

Is an estate of a deceased person, or a trust under a will or intestacy a settlement-arrangement? This question does not arise for the purposes of the IT settlement provisions. Even if it is a settlement-arrangement the settlor, that is, testator (being dead) will not be subject to tax. The settlement-arrangement definition is used in other contexts where the issue does arise: see 56.5.1 (Is an estate a "settlement" within s.87 TCGA?).

58.2.4 *IHT definition of "settlement"*

The IHT definition of "settlement" is different again but (as noted above) for the purposes of this chapter (who is the settlor) it is similar to the standard IT/CGT definition.[13]

58.3 Definitions of "settlor"

58.3.1 *Terminology*

We need labels for the four different definitions, and I use the following terms:

(1) ***The standard IT/CGT definition of settlor***. This definition applies in the Income Tax Acts and TCGA "unless the context otherwise requires". In some cases the context does "otherwise require" because there is a separate definition of settlor. I cannot think of any other case where the context would "otherwise require". The standard IT/CGT definition does not apply for the IT settlement provisions or for s.86 TCGA, so it is not usually very important.

(2) ***The settlement-arrangement definition of settlor***. This is the definition which applies for the purposes of the IT settlement

12 56 TC 68 at p87.

13 For issues relating to categorisation of foreign institutions the differences are material: see 62.1.3 (IHT and IT/CGT settlements).

provisions. It is applied by reference in various other contexts.

(3) ***The CGT s.86 definition of settlor****:* the definition for the purposes of s.86 TCGA.

(4) ***The IHT definition of settlor****:* the definition for the purposes of IHT.

Equipped with this terminology we can now consider the various definitions of settlor.

58.3.2 *The standard IT/CGT definition of settlor*

Section 467(1) ITA provides:[14]

> In the Income Tax Acts (except where the context otherwise requires) "settlor", in relation to a settlement, means the person, or any of the persons, who has made the settlement.

Section 467 ITA sets out various circumstances in which a person is treated as having made a settlement:

> (3) A person ("S") is treated for the purposes of the Income Tax Acts as having made a settlement if—
>
> (a) S has made or entered into the settlement (directly or indirectly),

There are four possibilities here:

(1) S is treated as having made a settlement if he has made the settlement directly. This is a tautology.

(2) S is treated as having made a settlement if he has made a settlement indirectly. I am unable to see how one can make a settlement indirectly.

(3) and (4) S is treated as making a settlement if he has entered into it. These words have been lifted from the context of the settlement-arrangement definitions of settlement and are not apt here.

I conclude that s.467(3)(a) achieves nothing, but it does no harm. One

14 The legislation is set out in full in ITA and TCGA, but there are no significant differences, so I give the text of ITA only. The CGT equivalent here is s.68A TCGA.

might take from it a general intent that "making a settlement" is not to be construed narrowly.

Section 467 ITA continues:

> (3) A person ("S") is treated for the purposes of the Income Tax Acts as having made a settlement if ...
> (b) the settled property, or property from which the settled property derives, is or includes property within subsection (4).
> (4) Property is within this subsection if—
> (a) the settlement arose on S's death (whether by S's will, on S's intestacy or in any other way), and
> (b) immediately before S's death, the property was property of S—
> (i) which was disposable property (see section 468), or
> (ii) which represented S's severable share in any property to which S was beneficially entitled as joint tenant.

Section 467(4) is necessary because an intestate does not "make or enter into" the trusts arising on intestacy; and it might perhaps be argued that a testator does not "make or enter into" the trusts arising under his will.[15] Section 467 continues:

> (5) In particular, S is treated for the purposes of the Income Tax Acts as having made a settlement if—
> (a) S has provided property for the purposes of the settlement (directly or indirectly), or
> (b) S has undertaken to do that.
> (6) If a person ("A") makes or enters into a settlement in accordance with reciprocal arrangements with another person ("B")—
> (a) B is treated for the purposes of the Income Tax Acts as having made the settlement, and
> (b) A is not to be treated for the purposes of the Income Tax Acts as having made the settlement just because of the reciprocal arrangements.

So far the definition of settlor is almost the same as the settlement-arrangement definition, the only difference is that the wording is recast in accordance with the conventions of plain English drafting and will trusts

15 See 56.5.1 (Is an estate a "settlement" within s.87 TCGA?).

are included.

58.3.3 *"Settlor of property"*

Section 467(2) ITA provides a commonsense definition of this expression:

> In the Income Tax Acts (except where the context otherwise requires) a person is a settlor of property if—
> (a) the property is settled property because of—
> (i) the person's having made the settlement, or
> (ii) an event which leads to the person being treated by this Chapter as having made the settlement, or
> (b) the property derives from settled property within paragraph (a).

58.3.4 *Settlement-arrangement definition of settlor*

Section 620 ITTOIA provides the settlement-arrangement definition:

> (1) In this Chapter ...
> "settlor", in relation to a settlement, means any person by whom the settlement was made.
> (2) A person is treated for the purposes of this Chapter as having made a settlement if the person has made or entered into the settlement directly or indirectly.
> (3) A person is, in particular, treated as having made a settlement if the person—
> (a) has provided funds directly or indirectly for the purpose of the settlement,
> (b) has undertaken to provide funds directly or indirectly for the purpose of the settlement, or
> (c) has made a reciprocal arrangement with another person for the other person to make or enter into the settlement.

One can identify five parts of the definition. A person is a settlor if and only[16] if he has:

(1) made the settlement directly or indirectly;

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16 "Means" in s.620(1) is the term used for an exhaustive definition. The context shows that the words "is treated as" in s.620(2)(3) also constitute an exhaustive (not inclusive) definition.

(2) "entered into"[17] the settlement directly or indirectly;
(3) provided funds directly or indirectly for the purpose of the settlement;
(4) undertaken to provide funds directly or indirectly for the purpose of the settlement;[18] or
(5) made a reciprocal arrangement with another person to make or enter into the settlement.

58.3.5 *IHT definition of settlor*

Section 44(1) IHTA provides the IHT definition:

> In this Act "settlor", in relation to a settlement, includes[19] any person by whom the settlement was made directly or indirectly, and in particular (but without prejudice to the generality of the preceding words) includes any person who has provided funds directly or indirectly for the purpose of or in connection with the settlement or has made with any other person a reciprocal arrangement for that other person to make the settlement.

The IHT definition expands "for the purpose of the settlement" into "for the purpose of *or in connection with* the settlement". Why? Does it make a difference and if so, what? In my opinion the words make no difference, for if something is provided "in connection with" a settlement it must be

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17 The words "entered into" are not found in the CGT s.86 or IHT definitions of "settlor". The reason is that (in the context of the settlement-arrangement definition) the word "settlement" includes an agreement or arrangement. One is said to "enter into" an agreement or arrangement even though it is not normal usage to say that one "enters into" a settlement (in the classic sense).
The drafter of the standard IT/CGT definition did not realise this, so he included the words infelicitously, though no harm is done.

18 In practice HMRC ignore this. TSE Manual provides at 4120: "In practice if someone has undertaken to provide funds, but actually does not, we would not seek to apply s.624 or s.629 ITTOIA." Undertakings to provide funds are not found in practice so this has no practical relevance. The IHT and CGT s.86 definitions omits this, presumably it was though to be unnecessary. The drafter of the standard IT/CGT definition included the words; if he had thought about this he would presumably have omitted then, but no harm is done.

19 The IHT definition (unlike the other definitions) uses the non-exhaustive "includes". Perhaps the drafter of the IHT provision had in mind a case where a person was the "settlor" of a settlement in the natural sense of the word but was not within the IHT definition. I cannot think of such a case.

provided "for the purposes of" the settlement; one must bear in mind that "purpose" does not need to be a very focussed or intense purpose.[20] The attraction of this view is that it makes the "who is the settlor" area of tax law more coherent if (so far as possible) the same test applies for all the taxes.[21]

There are specific IHT provisions which may affect the identity of the settlement and settlor for IHT. So sometimes a person who is the actual settlor in the general sense is not regarded as the settlor for IHT. This chapter considers the general sense of settlor; for the IHT provisions see 46.1 (Transfers between trusts).

58.3.6 *CGT s.86 definition of settlor*

TCGA Schedule 5 paras 7, 8 provide the CGT s.86 definition:

> *Meaning of "settlor"*
> 7 For the purposes of section 86 and this Schedule, a person is a settlor in relation to a settlement if the settled property consists of or includes property originating from him.
>
> *Meaning of "originating"*
> 8– (1) References in section 86 and this Schedule to property originating from a person are references to—
> (a) property provided by that person;
> (b) property representing property falling within para (a) above;
> (c) so much of any property representing both property falling within para (a) above and other property as, on a just apportionment, can be taken to represent property so falling.
>
> ...
>
> (3) Where a person who is a settlor in relation to a settlement makes reciprocal arrangements with another person for the provision of property or income, for the purposes of this paragraph—

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20 See 58.24 (Purpose: minor settlors).

21 Why then did the drafter use a different form of words, if he wanted the same result? Perhaps the reason is that "settlement" for IHT is narrower than settlement-arrangement. The drafter may have considered cases where it may have been argued that A is a settlor of a settlement-arrangement (providing property for the purpose of the *arrangement*) but A is not a settlor for IHT purposes (not providing for the purposes of the (IHT settlement). For instance in *Crossland v Hawkins* the taxpayer would have accepted that he was the settlor of the "arrangement" but (unsuccessfully) denied being the settlor of the classic settlement. To anticipate such arguments the drafter added the words "or in connection with".

> (a) property or income provided by the other person in pursuance of the arrangements shall be treated as provided by the settlor, but
> (b) property or income provided by the settlor in pursuance of the arrangements shall be treated as provided by the other person (and not by the settlor).
>
> ...
>
> (6) For the purposes of this paragraph references to property representing other property include references to property representing accumulated income from that other property.
> (7) For the purposes of this paragraph property or income is provided by a person if it is provided directly or indirectly by the person.

There are further provisions relating to property provided by a company, not discussed here. The CGT s.86 definition does not have the words "for the purpose of the settlement". Instead what is provided must be the "settled property". This is slightly narrower. What is provided must necessarily be for the purpose of the settlement (or it would not become settled property).

58.3.7 *Person ceasing to be a settlor*

Section 469 ITA provides for someone to cease to be a settlor:

> **Person ceasing to be a settlor**
> (1) A person ("S") who is a settlor in relation to a settlement ceases to be so when the following condition is met.
> (2) The condition is that—
> (a) no property of which S is the settlor is comprised in the settlement,
> (b) S has not undertaken to provide property (directly or indirectly) for the purposes of the settlement in the future, and
> (c) S has not made reciprocal arrangements with another person for that other person to enter into the settlement in the future.

This section is not expressed to apply only to the standard IT/CGT definition of settlor, so it is considered that it also applies to the settlement-arrangement definition too.

This has no equivalent in the IHT definition of "settlor", though it might, perhaps, be implied.

58.3.8 *Relevance of case law and HMRC statements*

In keeping with the patchwork nature of UK tax law, the definitions of settlor are based on a common framework but they all have slight differences from each other. The settlement-arrangement definition dates back to 1936 and is the ancestor of the other definitions. In IHT there has been a little tidying up of the settlement-arrangement definition; the CGT s.86 definition is perhaps an attempt to extract its essence. There is a simple concept underlying all the definitions which also represents the normal meaning of the word in trust law.[22] In most cases the differences in wording between the definitions have no significance.

Cases on one statutory provision will generally be relevant to them all. There are circumstances where a person is a settlor within the settlement-arrangement definition but not otherwise, but that is because the definition of "settlement" is different in this context.[23] There is also a link between the concept of bounty which is a requirement of a settlement-arrangement and the concept of providing property for the purposes of a settlement, so cases on what is "settlement-arrangement" can also be relevant to the question of who is the settlor.[24] For the same reason, HMRC statements made in connection with one provision are generally applicable to the other provisions.

58.3.9 *Two settlors*

A trust may have two settlors in various circumstances:

(1) A provides property and B has "made" or "entered into" the settlement without providing property.
(2) A provides property and B provides other property.
(3) Possibly, if A provides property directly and B provides the same property indirectly.[25]

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22 Contrast the definition in Article 1 Trusts (Jersey) Law 1984 ("a person who provides trust property or makes a testamentary disposition on trust or to a trust").

23 See 58.8 (Assignment or surrender of equitable interest).

24 See 58.2.3 (Settlement-arrangement).

25 See 58.4 (Gift from A to B followed by gift to trust by B)

The consequences are discussed in 46.4 (The separate settlements fiction); 37.12 (Two settlors for CGT s.86 charge).

58.3.10 *Tainting*

It does not generally matter if someone provides a trivial amount of property to his own or anyone else's trust. But occasionally penal tax rules apply if even nominal value is added. This is known as "**tainting**" a trust. The most common examples are:

(1) Any provision of funds to a pre-1991 trust may bring the trust within s.86 TCGA: Schedule 5 para 9(3).
(2) Any provision of funds by a UK-linked person will lose the benefit of the mixed resident trustee rules for trustee residence.[26]

In these cases, the question of when funds are provided may also arise.

58.3.11 *Commentary*

Three definitions of "settlement" seems complicated, but there are material differences between them and each definition is appropriate in its own context. However, four definitions of "settlor" is extravagant, for there is very little if any difference between them.

A rational tax system would have one standard definition of settlor, which would apply for all taxes. Until 2006 we had a number of definitions of settlor in different contexts, which had developed piecemeal as the tax system grew. The FA 2006 introduced the standard IT/CGT definition but only applied it for some (not all) purposes of IT and CGT. It has therefore increased the number of definitions of "settlor" and made a complex situation rather more complex. This is particularly curious because the authors of the proposals were emphatic that the two old definitions of trustee residence (a CGT and an IT definition) should be replaced by a single definition. We live in bad times for UK tax policy, but eventually, hopefully, someone will tidy up this mess. It would not be very hard to introduce a single definition.

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26 See 4.8 (Trust residence condition C).

58.4 Gift from A to B followed by gift to trust by B

Suppose:

(1) A gives property to B unconditionally;[27] and
(2) B gives the same[28] property to a trust.

Two "settlor" questions arise:[29]

(1) In what circumstances does one say that the A is the settlor of the trust, having provided the property indirectly? That is, what is the meaning of "providing indirectly"?
(2) If A is the settlor (having provided property indirectly), can one say that B is not a settlor, perhaps on the grounds that A is the "real" settlor?

One might expect to find guidance to these questions in *Hatton v IRC.*[30] The facts were as follows:

(1) Mrs Cole ("the mother") made a settlement ("the first settlement") conferring on her daughter Mrs Hatton a valuable equitable interest.
(2) The daughter transferred her interest to a new settlement ("the second settlement").

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27 It is different if the gift from A to B is made on terms which require B to transfer the property to the trust. It is also different if *Furniss v Dawson* applies. In those cases, clearly:
(1) A would be the settlor,
(2) B would not be a settlor.
It is also different if the gift from A to B is made by instrument of variation: see 58.30 (Trust made by instrument of variation).

28 Similar points arise if B gives other property (not the property given by A) if this is part of the arrangement between A and B.

29 Other issues may also arise. If A is a beneficiary of the trust, his gift to B may become a gift with reservation: see 45.5.2 (Gift from A to B followed by gift to trust by B). Note that even if A is a settlor of the discretionary trust, he has not made a chargeable transfer and no IHT is payable by A on the gift to the trust by B.

30 67 TC 759. For another aspect of this decision see 58.25 (Purpose: advisers and agents of settlor).

So this was in essence a case of a gift to B followed by gift to trust by B. It is important to note the background facts:

> Once the first settlement had been executed ... it was a virtual certainty that the second would be made on the following day provided that [the mother] was then still living.[31]

58.4.1 *When is A an indirect settlor?*

The Special Commissioners found:

> [the mother] was a settlor of the second settlement having directly or indirectly provided the only funds which were subjected to it.[32]

Chadwick J held (67 TC at 789):

> The Special Commissioners ... held that [the mother] was properly to be treated as a settlor of the second settlement on the ground that, by making the first settlement, [the mother] was a person who had provided funds directly or indirectly for the purpose of or in connection with the second settlement; and so, in relation to the second settlement, fell within the definition [of settlor]. In my view, they were entitled to reach that conclusion on the facts.

Hatton represents a relatively clear case of providing funds indirectly because the two gifts (from A to B and from B to the trust) were part of a pre-planned scheme and it was a "virtual certainty" that the second gift would follow the first. Are these essential requirements? The Special Commissioners, and the court, did not address this crucial point.

It is clearly not sufficient that B's funds are historically derived from A. Something more is required, but what? It might be said that all paraphrases are suspect and the court must return to the words of the statute. But when the words are so vague, some gloss is necessary to avoid hopeless uncertainty. At first sight, the concept of a "clean break"

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31 67 TC at 771. The Special Commissioners added:

> [The daughter] was content to leave the details to [the mother's advisers]. There was no real likelihood that she would reject the suggestion that she should make the second settlement when Mr Willcox [her adviser] put it to her.

But nothing turns on that.

32 At p.768G.

seems a useful one for determining whether property is provided indirectly. That is, if there is a clean break between A's gift and B's gift, A has not provided property indirectly. But "clean break" is only a metaphor which itself needs elucidation. It is not much more than a colourful label. It is suggested that A is a settlor (having provided property indirectly) only if (like *Hatton*) there is an arrangement under which:

(1) A makes a gift of property to B, and intends that B should promptly make the gift to the trust.
(2) B gives the property to a trust in fulfilment of the wishes of A.
(3) It is virtually certain that B's gift will be made.

Of course, this formulation will not solve all problems, since the questions may arise as to whether there is an "arrangement", what is A's intention and whether B makes a gift in fulfilment of A's wishes. But this is perhaps the best that can be done. It is consistent with the "conscious association" comments in *Fitzwilliam*.[33] It might be said that this is too narrow a test and it favours the taxpayer as it allows tax planning of the kind considered in 58.34 (Planning to create trust with foreign domiciled settlor). However, the planning is not all that easy! No looser test can be applied without considerable uncertainty. Moreover (see below), the consequences of A being an indirect settlor is that B is not a settlor; this strongly suggests a narrower test is appropriate for if B is a genuinely independent agent he should be the settlor.

58.4.2 *If A is indirect settlor, is B also the settlor?*

In *Hatton* the Special Commissioners held that the daughter did not provide the funds for the second settlement.[34] The reason was, it appears, that the mother had provided the funds indirectly and this excluded the possibility that the daughter had provided them.

Chadwick J held on the appeal that it was immaterial (for the purposes

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33 See 58.6 (Appointment to B followed by gift to new trust by B).

34 Page 768 at H. Confusingly, the Special Commissioners also say that the daughter *was* a settlor within the IHT definition. The reason, presumably, is that, although she did not provide property, she was a person by whom the second settlement was made. But nothing turns on that.

of the IHT provisions being considered) whether the daughter was also a settlor of the settlement.[35] The general tenor of the judge's comments seems to have been that the daughter was a settlor. His comments on this point were ambiguous[36] and, in our system of precedent, it is wrong to carefully weigh up ambiguous *obiter dicta* in order to extract a view.

Approaching the matter as one of principle, untrammelled by authority, it is respectfully suggested that the Special Commissioners' approach is to be preferred. While as a matter of logic it is possible for A to provide property indirectly, and B to provide it directly, the legislation is framed on the basis that trust property can have only one "provider". This is clearly the case for the IT and CGT settlement provisions.[37] It is suggested that the IHT definition should be construed consistently. If property is provided indirectly by A, it should not be regarded as provided by B at all.

58.4.3 *HMRC views*

TSEM 4300 [December 2007] provides:

> **Example 16– children –indirect gift of shares from parent**
> Mr J owns all 100 issued £1 shares in J Limited. Mr J is the sole company director and is the person responsible for making all the company's profits because of his knowledge, expertise and hard work. On starting up the company, Mr J allowed his mother to subscribe £40 for 40% of the shares but *shortly afterwards* she gifted them to her grandchildren. The circumstances are such that the decision to issue 40 shares at par is a bounteous arrangement (as were the shares in *Jones v Garnett*).

This is essentially a case of:

(1) A gift from Mr J to the grandmother; and
(2) A gift from the grandmother to the grandchildren.

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35 Page 791 at B.

36 The conclusion that the mother was a settlor "did not lead, necessarily, to the further conclusion that [the daughter] was not also a settlor". See p.791 at B.

37 Otherwise there would be double taxation, for under s.644(1) ITTOIA, A and B would both be taxed in full on the income, which cannot be correct. Likewise for CGT: para 9 Sch 5 TCGA.

The Manual's tax analysis is as follows:

> The true settlor here is Mr J *rather than the children's grandmother*. Section 629 therefore applies and attributes the dividends received by the children to Mr J for tax purposes.

The words in italics suggest that HMRC accept the views set out above.

58.5 Trust created by B at request of A

> Suppose that a man owing a debt of honour or of gratitude to a friend, without any legal obligation proposed to discharge it by paying £1,000 to the friend, and that the latter asks that the sum be paid not to him but to the trustees of a settlement, which is done. The payment of the money to the trustees would obviously be a provision of funds for the settlement. On a purely objective view the payer could be said to have made that provision, but I think that the friend should properly be regarded as the person making this provision. It would be just as if the money had been first paid to him and then paid by him to the trustees. *The payer would have acted at his behest.*[38]

This *obiter* comment is right if (as Buckley LJ assumes) the payer agrees (albeit without legal obligation) to make the payment at the direction of the friend so that the friend has *de facto* (though not *de jure*) power of disposition of the funds. The situation is different if a father proposed to make a gift to his son, and the son merely *asks* that the sum be paid to trustees of a settlement for himself and his family. For a father will feel moral obligations to his grandchildren as well as to his son; the father has no (even non-binding) obligation to make a payment to his son; the son has no *de facto* power of disposition over the funds; in such circumstances the father (not the son) is the settlor. The son has not provided funds even indirectly.

If A asks B to transfer a nominal sum as an initial trust fund, and B does so, not because he wishes to benefit the beneficiaries by the payment, but because A has asked him to, as a favour to A, then applying this principle, A is the (indirect) settlor.

38 *Mills v IRC* 49 TC at 387 (Buckley LJ).

58.6 Appointment from old trust to B followed by gift to new trust by B

Fitzwilliam v IRC 67 TC 614 concerned an arrangement under which:

(1) Trustees of a will trust exercised their power of appointment ("step 3") to confer a valuable equitable interest on Lady Hastings.
(2) Lady Hastings transferred this interest to a new trust a few days later ("step 5").

So this was a relatively simple case of an appointment from the will trust to B followed by a gift to a new trust by B. The question was who was the settlor of the new trust: Lady Hastings or the testator of the will trust (or both). Lord Keith said:

> The argument for the Crown is that, by virtue of the appointment contained in step 3, property was provided to Lady Hastings directly or indirectly for the purpose of or in connection with the settlement which Lady Hastings later made under step 5. The person who provided that property is said to be Earl Fitzwilliam [the testator], because the appointment by the trustees falls to be read back into his will, under the principle of *Muir v Muir* [1943] AC 468 and *Pilkington v IRC* [1964] AC 612. These cases decided that for the purposes of the Scottish rule against successive liferents and the English rule against perpetuities the exercise of a power of appointment must be written into the instrument creating the power. Earl Fitzwilliam is, therefore, to be treated as the settlor so far as concerns the trust purposes contained in the appointment made by his trustees under step 3, but he cannot reasonably be regarded as having provided property directly or indirectly for the purpose of or in connection with the settlement made by Lady Hastings under step 5.
>
> The words "for the purpose of or in connection with" connote that there must *at least be a conscious association of the provider of the funds* with the settlement in question. It is clearly not sufficient that the settled funds should historically have been derived from the provider of them. If it were otherwise anyone who gave funds unconditionally to another which that other later settled would fall to be treated as the settlor or as a settlor of the funds. It is clear that in the present situation there cannot possibly have been any conscious association of Earl Fitzwilliam with Lady Hastings' settlement.

(*Fitzwilliam v IRC* 67 TC at 732, emphasis added)

It seems therefore that if:

(1) a trust ("trust A") exists and A is its settlor;
(2) there is an arrangement under which:
  (a) the trustees of trust A appoint trust property to B;
  (b) B gives the property to a separate trust ("trust B");

B will be the settlor of trust B, and A will not be a settlor, unless the creation of trust B is envisaged by A at the time that trust A is made.

The "conscious association" test is an understandable and generally helpful paraphrase of the statutory words (though of course it does not solve much as the question may arise as to what is a "conscious association". Further, Lord Keith said there must *at least* be a conscious association, suggesting that it is a necessary, but may not be a sufficient, condition). The application of the conscious association test in the context of an appointment followed by a gift really is surprising, but the House of Lords have spoken. The matter is for most practical purposes ended – unless and until the House of Lords speak again. For implications for tax planning, see 58.34 (Planning to create settlement with foreign domiciled settlor).

58.7 Transfer from trust A to trust B by exercise of trustees' power

This section considers the general sense of settlor. Special rules apply for IHT: see 46.1 (Transfers between trusts – Introduction).

58.7.1 *Transfer from trust A to new trust created by trustees*

Suppose:

(1) Trustees of a trust made by A ("Trust A") have power to transfer to a new trust.
(2) The trustees transfer the trust fund to new trustees to hold on the terms of a newly created trust, Trust B. All the funds of Trust B are derived from Trust A.

Who is the settlor (in the general sense) of Trust B? The trustees of Trust A cannot be the "settlor" as they have merely exercised a fiduciary power. So either A is the settlor or there is no settlor.[39] The answer is that A is the settlor of Trust B. In *Eilbeck v Rawling* 54 TC 101:

(1) a Gibraltar settlement ("Trust A") made by "Settlor A" held £600,000;
(2) a Jersey settlement ("Trust B") made by "Settlor B" held £100;
(3) £315,000 was transferred from Trust A to Trust B by exercise of the trustees' powers.

Buckley LJ said at p.161:

> The donee of a special power of appointment is charged with the exercise of a personal discretion which he cannot delegate. When he exercises that discretion in making an appointment, he acts as the delegate of the settlor. What the donee does in exercise of a special power of appointment is done vicariously by the settlor. It is also settled law of long standing that, for the purposes of the rule against perpetuities, when a special power is exercised, the limitations created under it are to be written into the instrument which created the power. This association of the interests arising under an appointment in the exercise of a special power with the settlement conferring that power is not, in my opinion, confined to the rule against perpetuities. If one asks who was the settlor of the £315,000 appointed by the appointment of 27 March 1975, the only possible answer is [Settlor A] the settlor of the £600,000 comprised in the Gibraltar settlement [Trust A]. The taxpayer's brother [Settlor B] did not settle[40] the £315,000; he settled only £100. The Gibraltar trustee [the trustees of Trust A] did not settle the £315,000; it was not the Gibraltar trustee's to settle, and making the appointment the Gibraltar trustee was only exercising a fiduciary power conferred on him by the Gibraltar settlor [Settlor A], whose delegate he was as donee of the power. The exercise of the power had, in my opinion, precisely the same effect as if the Gibraltar trustee had appointed the £315,000 in favour of the Jersey trustee to be held upon trusts identical with the trusts of the Jersey settlement [Trust B] but set out in extenso in the appointment without reference to the Jersey settlement. If the appointment had taken that form, there could, I think, be no doubt that the trusts so appointed would be trusts taking effect

39 If at the time of the creation of Trust A, the transfer to Trust B is already in contemplation, then A is the settlor of Trust B. It is here assumed that the transfer was not in contemplation at the time of the creation of Trust A.

40 Buckley is using the word "settle" as a paraphrase of the statutory word "provide".

under the Gibraltar settlement.

The House of Lords approved this reasoning on appeal.[41]

HMRC agree. The CG Manual provides:

> **33241 Settlor** [June 2003]
> Where trustees exercise a special power of appointment, or power of advancement, in such a way as to create a new settlement, see CG33800+, the settlor of the new settlement is the person who was the settlor of the old one. See, for example, *Pilkington v IRC*, 40 TC 416, p.442[42] and *Chinn v Collins*, 54 TC 311, p.351H.

The same point is made again at 34802.

It is considered that the same applies to a transfer for less than full consideration made in exercise of trustees dispositive powers, e.g. an interest-free loan from trust A to trust B.

58.7.2 *Transfer from trust A to existing trust made by B*

Suppose:

(1) A transfers property ("A's fund") to a trust ("trust A"). The trustees have the standard power to transfer property to another trust.
(2) B transfers property ("B's fund") to a separate trust ("trust B").
(3) The trustees of trust A transfer A's fund to trust B.

Trust B now has two settlors: A has provided A's fund indirectly, and B

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41 It may be objected that this is not consistent with *Fitzwilliam*: see 58.6 (Appointment from old trust to B followed by gift to new trust by B). There is no "conscious association" between A and Trust B. However, *Fitzwilliam* was a case where the Court found that an individual beneficiary who assigned an asset to the new trust was the "settlor". The beneficiary displaced the testator from being a settlor by his independent act. There is no equivalent here.
The alternative conclusion that Trust B has no settlor for general tax purposes would have the result, attractive to taxpayers but absurd, that A might escape CGT on trust income and gains under the settlement provisions. The property in Trust B could be excluded property, as one could not say that "the settlor" was domiciled in the UK at the time that the settlement was made! That can hardly be right.
If (which is doubtful) further authority is needed, see *Trennary v West* [2005] STC 214 at [49].

42 [Author's note] See 58.12.2 (Power of advancement).

has provided B's fund directly.

58.7.3 *IT and CGT rule*

Section 470 ITA provides:[43]

> **Transfers between settlements**
> (1) Section 471 applies in relation to a transfer of property[44] from the trustees of one settlement ("settlement 1") to the trustees of another settlement ("settlement 2") if the transfer—
> (a) is not for full consideration,
> (b) is not by way of a bargain made at arm's length, and
> (c) is not excluded by subsection (2).

Section 470(2) ITA sets out three exceptions:

> A transfer of property is excluded for the purposes of subsection (1) if—
> (a) it occurs only because of the assignment by a beneficiary under settlement 1 of an interest in that settlement to the trustees of settlement 2,
> (b) it occurs only because of the exercise of a general power of appointment, or
> (c) section 473(4) applies in relation to it.[45]

In short, s.741 applies on a transfer between trusts by exercise of a trustee's power.

This takes us to s.471 ITA:

> **Identification of settlor following transfer covered by section 470**
> (1) If there is a transfer of property in relation to which this section

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43 The CGT equivalent is s.68B TCGA.

44 The expression "transfer of property" is defied in s.470(3) ITA:
"(3) In this section 'transfer of property' means—
(a) a disposal of property by the trustees of settlement 1, and
(b) the acquisition by the trustees of settlement 2 of—
(i) property disposed of by the trustees of settlement 1, or
(ii) property created by the disposal.
(4) For the purposes of subsection (3) there is an acquisition or disposal of property if there would be an acquisition or disposal of property for the purposes of TCGA 1992."

45 For this exception see 58.31 (IT & CGT – IoVs from 6 April 2006).

> applies, then the following subsections apply for the purposes of the Income Tax Acts, except so far as, in those Acts, the context otherwise requires.
> (2) The settlor (or each settlor) of the property disposed of by the trustees of settlement 1 ("the disposed property") is treated from the time of the disposal as having made settlement 2.
> (3) If there is more than one settlor of the disposed property, each of them is treated in relation to settlement 2 as the settlor of a proportionate part of the property acquired by the trustees of settlement 2 on the disposal.
> (4) So far as the disposed property—
> (a) was provided for the purposes of settlement 1, or
> (b) was derived from property so provided,
> the property acquired by the trustees of settlement 2 on the disposal is treated from the time of the disposal as having been provided for the purposes of settlement 2.
> (5) If as a result of subsection (4), property ("the transferred property") is treated as having been provided for the purposes of settlement 2—
> (a) the person who provided the disposed property, or the property from which it was derived, for the purposes of settlement 1 is treated as having provided the transferred property for the purposes of settlement 2, and
> (b) if more than one person provided the disposed property, or the property from which it was derived, for the purposes of settlement 1, each of them is treated as having provided a proportionate part of the transferred property for the purposes of settlement 2.

This applies for IT and CGT purposes. But it is considered that this only codifies the general law position, so there is no difference here between IT/CGT and IHT.

58.8 Assignment or surrender of equitable interest

A person who assigns an equitable interest under Trust A to Trust B is the settlor of Trust B but does not of course become the settlor of Trust A.

If a person surrenders an equitable interest under Trust A there is no "Trust B". In that case, that person is the settlor for the settlement-arrangement definition[46] so far as he has provided the income, but he is not a settlor of Trust A for the IHT definition, the CGT s.86 definition, or

46 *IRC v Buchanan* 37 TC 362.

the standard IT/CGT definition.

HMRC agree: CG Manual 33242 provides:

> **Settlor** [February 2005]
> Normally the same person is the settlor for both Income Tax and CGT. But this is not the case where a person has assigned a right to income. Such an assignment cannot affect the identity of the settlor for CGT purposes.

The position is similar to a variation of trust by beneficiaries; see below.

58.9 Disclaimer

TSEM states at 1840:

> The person disclaiming is not a "settlor" within [the settlement-arrangement definition] (TSEM4120). Subsequent trusts that result from the disclaimer retain their original settlor.

A disclaimer, if possible, may be preferable to a surrender or assignment. The distinction between a disclaimer and a surrender/assignment is therefore important. This raises questions of trust law which cannot be fully discussed here, but for a broad outline see TSEM para 1840 [January 2008]:

> A person uses a true disclaimer to refuse a gift due under a trust. Effectively the person steps aside. This allows subsequent provisions of the trust to take effect.
> A disclaimer can relate to
> - capital
> - income
> - both.
>
> A disclaimer has retrospective effect. It applies from the date that the entitlement arose. There may be a lapse of time between the entitlement arising and the disclaimer. This is not conclusive evidence that the deed cannot be a true disclaimer. ...
> The person making a disclaimer may still benefit from another part of the trust income or capital. This is irrelevant. If that person seeks to impose new trusts, the deed is not a disclaimer. It is an assignment (TSEM1845).

58.10 Variation or resettlement by beneficiaries

58.10.1 *The trust law background*

Beneficiaries who are adult and absolutely entitled to trust property[47] may:

(1) create a new settlement ("a resettlement") or
(2) (with the consent of the trustees) vary the terms of an existing settlement ("a variation").[48]

The distinction between a variation and a resettlement is crucial, but careful drafting will normally achieve whichever is desired.
HMRC accept this. The CG Manual provides:

> **Variations of trusts**
> **37880. By agreement**
> If all the beneficiaries of the trust are 18 or over and agree, they may bring it to an end and share out between themselves (and others) the trust property. (There is an exception to this rule in Scotland in that a person with an alimentary liferent cannot exercise consent in this way.) In these circumstances there is a deemed disposal by the trustees of the whole of the settled property under TCGA 1992, s.71(1).

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47 If there are minor and unborn beneficiaries, a variation can similarly be made with the consent of the court under the VTA 1958.

48 See s.1(1) VTA 1958 which assumes that beneficiaries have power to vary a trust:
> "Where property...is held on trusts arising...under any will, settlement or other disposition, the court may if it thinks fit by order approve on behalf of [unborn or unascertained beneficiaries] any arrangement ... *varying* or revoking all or any of the trusts, or enlarging the powers of the trustees of managing or administering any of the property subject to the trusts. ..."

This assumes that the Court only approves on behalf of unborn or unascertained beneficiaries, and adult beneficiaries can make a variation without the approval of the Court. See *Re Holt* [1969] 1 Ch 100 at p.120:
> "Under an arrangement approved by the court [under the Variation of Trusts Act 1958] the trusts may be brought wholly to an end. On the other hand, they may be varied; and there is no limit, other than the discretion of the court and the agreement of the parties, to the variation which may be made. Any variation owes its authority not to anything in the initial settlement but to the statute and the consent of the adults coming, as it were, ab extra. *This certainly seems to be so in any case not within the Act where a variation or resettlement is made under the doctrine of Saunders v. Vautier by all the adults joining together*; and I cannot see any real difference in principle in a case where the court exercises its jurisdiction on behalf of the infants under the Act of 1958."

37881.

It is also possible, with the consent of the trustees, to vary the terms of the trust. There are all kinds of variation possible. Some property may pass absolutely to beneficiaries or existing separate settlements. Clearly this must involve disposals under TCGA 1992,s. 71(1). Other property is held on the same trusts as before and/or on different trusts.

37882.

In such circumstances it is necessary to consider, in the light of the principles set out in the preceding paragraphs and also CG33290-33304, what the correct analysis is. The alternatives are

[1] mere variation of the terms of the existing settlement

[2] continuation of the old settlement as regards part of the property, with the remainder being held on one or more new settlements

[3] termination of the old settlement in its entirety being replaced by one or more new settlements. This last is an unlikely analysis unless a significant part of the property is being distributed absolutely. In such circumstances it may be helpful to refer to *Ewart v Taylor* where one reason for the court holding that a new settlement had come into existence was that it was part of a scheme for winding up the old settlement. See 57 TC 401 at 468, Section I.

...

37883. Under Variation of Trusts Act

The trusts of an existing settlement may be varied (in particular when the interests of unborn or minor beneficiaries are involved) by way of an Arrangement agreed between those parties of full age and approved by a Court Order under the Variation of Trusts Act 1958 (in Scotland Section 1 Trusts (Scotland) Act 1961) on behalf of those unable to give consent.

37884.

If so the principles of CG37880 –CG37882 apply. The degree of variation may exceptionally be such as to involve the termination of the original settlement in whole or in part and the creation of a new settlement. The fact that the courts may only consent to variation of the trusts does not prevent this. (If so then consideration must be given to the identity of the settlor, see CG37900.) A variation may also cause a beneficiary to become absolutely entitled to assets as against the trustees. ...

37886. Instrument of variation of will or intestacy [August 2007]

It is quite common for instruments of variation of wills or intestacies to be executed within two years of the testator's (or intestate's) death. In England & Wales the usual form of the instrument is a deed. The general guidance is at IHTM35011+ and guidance on CGT at CG31600+. If an instrument of variation creates a continuing trust which replaces absolute interests in the original will, and there is no statement of intent in the deed or before 1 August 2002 no election, under Section 62(7) TCGA 1992, or its predecessor Section 49(7) CGTA 1979, the person who gives up the absolute interest in favour of the trustees is to be regarded as the settlor for the purposes of the annual exempt amount and Section 77 TCGA 1992. His personal position is considered at CG32000+, assuming the variation is gratuitous.

This is obviously correct. The Manual then turns to our situation:

> **37887.** [August 2007]
> If, however, in a case where there is no such election or statement of intent, the will or intestacy provided for property to be held subject to trusts, and these trusts are varied or replaced by the deed of variation, then there are two questions to be answered.
> a. Is there a new separate settlement?
> b. If so, who is the settlor of that settlement?
> If there are only minor variations clearly there is no new settlement and the deceased remains the settlor. Minor variations would include for instance changes in the administrative powers of the trustees, or the provision of an ultimate gift over, that is, a provision saying to whom the property is to pass if the trusts fail, or the appropriation of property to particular funds within the settlement. Otherwise it is necessary to determine whether there is a new settlement in accordance with the principles explained at CG37882, and see CG37889. If there is a new settlement then the identity of the settlor should be determined in accordance with CG37900. ...
> **37889.** [August 2007]
> One situation which is quite common is where there is a life interest trust for the spouse of the deceased. For Inheritance Tax reasons this is partly varied so that there is a discretionary trust up to the amount of the Inheritance Tax nil rate band. In such a case, where the spouse continues to be a beneficiary of the new discretionary trust, it would often be appropriate to regard this, except for the purposes of Inheritance Tax, as little more than a cosmetic arrangement, particularly if the broad intention is that the bulk of the income should be paid to the spouse. So this would be regarded for Capital Gains Tax purposes as a variation of the original will trust, and not as giving rise to a new separate settlement. The deceased remains the settlor.

Para 37889 is a plain case.

58.10.2 *Tax consequences of resettlement*

A resettlement (unlike a variation) involves a disposal for CGT, and may lose the benefit of IHT relief for transitional serial interests. It also changes the settlor. The CG Manual provides:

37900. Identity of settlor
Where there is a variation of a trust of the kind described in CG37880+ [variation by beneficiaries] it is necessary to identify the settlor. If the conclusion taken is that there are no new settlements then for CGT purposes the identity of the settlor is unaffected. However if in effect interests in income have passed from one person to another, the former may well be the settlor of an arrangement for Income Tax purposes.
37901. Identity of settlor [August 2007]
If however one or more new settlements have come into existence, then the settlors of those settlements are one or more of the parties to the variation. The question should be tackled on a practical basis by determining where each beneficiary's share has gone. ...
37903. Example [August 2007]
Under a settlement made by X, A and B are each entitled to half the income. On A's death his son P gets half absolutely. On B's death her daughter Q gets half absolutely. The values of their respective interests are, say:

A's life interest	£60,000 [30% total value]
P's remainder	£40,000 [20% total value]
B's life interest	£75,000 [37.5% total value]
Q's remainder	£25,000 [12.5% total value]

Under the variation, which is considered to terminate the old settlement:
A takes 30% of the property.
20% goes to a new accumulation and maintenance settlement for P's children.
B takes 25% of the property.
The rest [25%] is held for Q for life with remainder to Q's son R.
P should be regarded as the settlor, for the purpose of the annual exempt amount, of the accumulation and maintenance settlement, because this is how his share has been dealt with.
B and Q equally should be regarded as the settlors of the other settlement. ...

58.11 Variation under Variation of Trusts Act 1958

Where a court approves a variation of trust on behalf of a minor beneficiary, under the VTA, it is considered that the minor beneficiary does not become a settlor. The reason is that the court in giving its approval does not merely act on behalf of the minor: the court has a wider role.[49] The position is analogous to trustees exercising a power of advancement.[50] But HMRC do not agree. CG Manual para 37902 provides:

> **Minor as settlor** [August 2007]
> It is considered that where a court has given consent on behalf of a minor, that minor can be a settlor. The authority lies in *Yates v Starkey*, 32 TC 38, where it was held that a person could be a settlor under compulsion, and *Mills v IRC*, 49 TC 367, where it was held that a minor with very little involvement in the transactions could be the settlor because she provided the property.

Neither of these cases justifies the HMRC view.

58.12 Exercise of power of appointment or advancement

58.12.1 *Special power of appointment*

The exercise of a special power of appointment does not make the appointor a settlor.[51]

58.12.2 *Power of advancement*

Where trustees have a power of advancement (that is, a power to apply trust property for the benefit of a beneficiary) they may use that power to transfer trust property to a new trust.[52] The consent of that beneficiary is not needed and therefore that beneficiary is not the settlor of the new trusts.

Pilkington v IRC concerned a proposal to transfer property to a new settlement by exercise of a power of advancement in favour of a Miss Penelope. Lord Radcliffe said:

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49 *Re Steed* [1960] 1 Ch 407; *Re Remnant* [1970] Ch 560. Further consideration is needed if foreign trust laws apply.

50 This view is consistent with the fact that where a Court approves a variation on behalf of an unborn beneficiary, that beneficiary clearly does not become a settlor.

51 This is self-evident, but if authority is needed, see the quotations set out in 58.7.1 (Transfer from trust A to new trust created by trustees).

52 See *Drafting Trusts and Will Trusts*, James Kessler QC, 8th ed., para 11.11 (Power of advancement used to create new trusts).

> When one asks what person can be regarded as the settlor of Miss Penelope's proposed settlement, I do not see how it is possible to say that she is herself or that the trustees are. She is the passive recipient of the benefit extracted for her from the original trusts; the trustees are merely exercising a fiduciary power in arranging for the desired limitations. It is not their property that constitutes the funds of Miss Penelope's settlement: it is the property subject to trusts by the will of the testator and passed over into the new settlement through the instrumentality of a power which by Statute is made appendant to those trust.[53]

HMRC agree: see CG 33241 set out in 58.7 (transfer from trust A to trust B by exercise of trustees' power).

58.12.3 *General power of appointment*

A general power of appointment (whether testamentary or not) may be used:

(1) in a manner which creates a new settlement, or
(2) in a manner which merely varies an existing settlement.[54]

In case (1) the appointor is the settlor of the new settlement. In case (2) it is considered that the appointor is not in principle the settlor, but is in the same position as a person who consents to the exercise of a power.

58.13 Consent to exercise of power

A trust sometimes provides that the trustees can only exercise a power of appointment with the consent of a particular beneficiary (typically the life tenant). If the power of consent is wholly personal (i.e. proprietary),[55] this raises some intriguing questions. An exposition is made more difficult by the variety of possible circumstances and taxes. In outline the position is as follows:

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53 *Pilkington v IRC* 40 TC 416 at p.442.
54 The position is analogous to 58.10 (Variation or resettlement by beneficiaries).
55 On this terminology and powers of consent generally see *Drafting Trusts and Will Trusts*, James Kessler QC (8th ed.) para 7.33 (Nature of powers of consent).

(1) A gratuitous consent to an appointment which terminates the consentor's interest in trust income probably makes the consentor the settlor, for the purposes of the settlement-arrangement definition. The consentor has provided income for the purpose of the settlement-arrangement because he has effectively given up his right to the income by his consent.[56]

(2) For similar reasons a gratuitous consent to an appointment which terminates the consentor's contingent interest in trust capital probably makes the consentor the settlor, for the purposes of standard IT/CGT and IHT[57] definitions from the time that the contingency is satisfied. The consentor has provided capital for the purposes of the settlement because he has effectively given up his right to the capital by virtue of his consent.

(3) By contrast, the giving of the consent to an appointment does not make the consentor a settlor (for any purpose) if:

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56 The position is analogous to a person who assigns or surrenders his life interest. The analogy is not exact. In one case the arrangement consists of the assignment alone. In the other case the arrangement consists of the consent and the exercise of the trustees' power of appointment. So in a sense there is an arrangement with two settlors: (i) the consentor and (ii) the (actual) settlor of the classic settlement who conferred the power of appointment on the trustees. But HMRC (or the actual settlor) may plausibly argue that the consentor (not the actual settlor) is taxable under the Settlement Provisions in these circumstances. They may take support from *Braybrooke v Att-Gen* 9 HLC 149 at p.165, accessible on *www.commonlii.org*. (A case on the Succession Duty Act 1853 whose provisions are analogous to the settlement provisions. Since Succession Duty was only abolished in 1949, the drafter of the original settlement provisions doubtless had it in mind.) The ground of the decision in *Braybrooke* was:

> "that, although the estate of the son arose under a joint power of appointment made by his father and himself, and although therefore the father was in a sense one of the settlors, yet he was not a settlor from whom the interest or any part of the interest of the son, in his character of successor, was derived. And the decision shews that, in order to ascertain who is the settlor 'from whom the interest of the successor is derived,' we must inquire, not who are the parties by whose conveyance the estate has been created, but who is the conveying party out of whose estate the interest in question has been derived." See *Att-Gen. v Charlton* (1877) 2 Ex. D. 398 at p.417.

57 It is arguable that the consentor is not a settlor for IHT because the power of consent is a settlement power and so not property for IHT purposes. It is the old question of how far one carries through the deeming provisions. The better view is that one does not carry the deeming that far.

(a) the consentor had no interest in the trust immediately before giving the consent; or

(b) the appointment leaves the interest of the consentor in the trust unaffected.[58]

In these cases the consentor has not provided any property by his consent.

(4) The giving of a consent is probably not a disposal for CGT[59] of:

(a) the right to consent (even if it is extinguished); or

(b) the consentor's interest in the trust (even if that is extinguished).

The contrary is arguable but it would not normally matter.[60]

(5) The giving of the consent is probably not a "disposal" for the purposes of the gift with reservation rule[61] and indeed it is likely that the power of consent is a "settlement power" and so not property for IHT: see s.272 IHTA.

HMRC do not appear to take any of these points at present; but there is cause for caution. The practical conclusion is that it is in principle better not to make a power of appointment subject to the consent of the life tenant (or any other beneficiary).

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58 This is fairly clear from first principles, but some support can be found in two cases. In *Braybrooke* (see above fn) a tenant in tail exercised his power to dispose of the lands entailed, with the consent of the protector. The protector was not the creator of the disposition: "It cannot be argued that a person whose consent is apparently necessary to a disposition, makes that disposition." In *Mills v IRC* the father's consent was apparently thought necessary for Hayley Mills to enter into the arrangements: see 49 TC 367 at p.403. This did not prevent Hayley being a settlor.

59 Under general principles or by virtue of s.24 TCGA (extinction of an asset constituting a disposal).

60 It will matter if the usual CGT exemption on the disposal of an equitable interest does not apply (e.g. offshore trusts). It could matter if the conditions of TCGA Sch. 4A are satisfied, but that would be unusual.

61 See *Baird v Baird* [1990] 2 AC 548 at 557 [the exercise of a power of appointment] "disposes of no property of the appointor". HMRC agreed. The old CTO Advanced Instruction Manual E.91 provided:

> "Nor should you regard the giving of a consent by a limited owner to the exercise of the power of advancement as the making of a disposition."

This passage does not seem to be in the current IHT Manual. This is one of a number of important statements (deliberately?) culled in the transition from the old to the new Manual. There is no reason to think that HMRC have changed their view.

58.14 Provision of property for company held by trust

HMRC take the view that provision of property to a company wholly owned by a trust is in principle provision of property for the purpose of the trust, and therefore makes the provider a settlor. SP 5/92 provides:

> 16 The condition in TCGA Sch 5 para 9(3)[62] may be satisfied where property or income is provided to a company in which the trustees are participators.[63]

This is supported by *obiter dicta* in *Crossland v Hawkins* 39 TC at p.506 followed by Goulding J in *IRC v Mills* 49 TC at p.337. It is correct for the standard IT/CGT definition, the settlement-arrangement definition and the IHT definition.

However, for the CGT s.86 definition, the question is not whether a person has provided property for the purpose of the settlement. The question is whether a person has provided *settled* property. So long as the property provided remains property of the company, not property of the trust, this condition is not satisfied.[64]

58.14.1 *Transactions with wholly owned companies*

SP 5/92 para 18 provides:

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62 The condition is that property is provided directly or indirectly for the purposes of the settlement.

63 The SP continues with an exception:

> "Where, however, the transaction is carried out with the sole object of leaving funds within the company for the company's purposes and it can be shown that any indirect benefit to the trust is merely incidental to that object, the transaction is disregarded for the purposes of para 9(3).
> 17 Examples of transactions which may be so disregarded are—
> – where another shareholder waives an entitlement to all or part of a dividend; or
> – where a director restricts withdrawals of remuneration voted,
> in order to assist the company's cash flow, and no payments are made, directly or indirectly, to the trustees as a result of this. All relevant factors will be considered in determining whether it is appropriate to apply this practice in a particular case."

64 This view, expressed in earlier editions of this work, is now supported by *Coombes v HMRC* [2008] STC 2984.

> 18 In general, transactions between trustees and companies which they, directly or indirectly, wholly own, or between such companies, are outside the scope of TCGA 1992 Sch 5 para 9(3).[65]

This is right. There can be no element of bounty so a wholly owned company cannot "provide" property to its owner, just as shareholders cannot "provide" property to their company.

58.15 Provision of services

58.15.1 *Services envisaged when settlement made*

In two cases:

(1) a third party created a trust which held a company; and
(2) well-known actors (Jack Hawkins, Hayley Mills) provided services to the company at a substantial undervalue. The company made profits transferred as dividends to the trustees.

In both cases there was clearly a settlement; the question was who was the settlor. It was held that the actor was the settlor.[66]

Viscount Dilhorne in *IRC v Mills* 49 TC at 408 considered two situations:

(1) The employees of a company held by trustees contribute by their labour to the profits of the company, and so increase the shareholders' dividends and so increase the income of the settlement.
(2) A stockbroker might, if the advice he gave to the trustees of a settlement proved well founded, be said to be contributing to the settlement.

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65 The SP sets out a commonsense definition of "wholly owned" and continues with a qualification:

> "This approach may not, however, be taken where, on the facts of a particular case, it appears that the transaction has been entered into solely or mainly for the purposes of obtaining a UK tax advantage."

66 *Crossland v Hawkins* 37 TC 493 approved *Jones v Garnett* [2007] STC 1536; *IRC v Mills* 49 TC 367. More accurately, the actor was one of the settlors but the contribution by the person who created the trust was ignored as insignificant.

One might have said that these were not settlors because they provide no bounty but what if they do act with gratuitous intent? Viscount Dilhorne did not rely on the bounty point:

> The difference between those cases, on the one hand, and *Crossland v Hawkins* and this case [*Mills*], on the other, is that in *Crossland v Hawkins* and in this case funds which ordinarily would have been received by Mr. Hawkins and by Miss Mills for their acting were diverted to companies which were channels for their transmission to trustees. It is not the provision of services but of funds which comes within the section.

The distinction is not between provision of services and provision of funds, because the actors did provide services; the distinction is between:

(1) the provision of services which yields funds; and
(2) the provision of services which does not yield funds.

When does the provision of services yield funds? It is suggested that the test should be whether one can identify funds which:

(1) would (in the absence of the settlement) have been received by the individual, but
(2) were diverted to the trust.

The settlement provisions do not work unless one can *identify* the funds which are provided by the settlor. In Viscount Dilhorne's examples of employees and stockbrokers, this condition is not met.

Suppose:

(1) an individual has an opportunity of purchasing land, or shares in a private company;
(2) he allows the trust to take up the offer by advising the trust and not pursuing the opportunity himself;
(3) had the trust not taken up the offer he would have done so.

In this case the individual is a settlor if one can distinguish the return from the trust's investment from the profit from the advice. A clear case being where the trust only invested a nominal amount in the project. But if the trust provides substantial funds for the development, one cannot identify any money as coming specifically from the adviser. One should not apportion the profits between the adviser's contribution (advice) and the settlement's contribution (finance). It is impractical to do so as there is no sufficiently clear answer to how the apportionment should be made. If that is right, the *Mills* and *Hawkins* line of cases is effectively restricted to "one-man companies" with no substantial capital (as was the case in both *Mills* and *Hawkins*). Tax Bulletin 64 Example 9 suggests that HMRC accept this. The example (slightly re-phrased) is as follows:

> Mr. J owns 60 of the 100 issued £1 shares in J Limited. Mr. J is the sole company director *and* is the person responsible for making *all* the company's profits because of his knowledge, expertise and hard work. The remaining 40 shares are held by the children of Mr. J and were originally owned by their grandmother who had subscribed for them at par when the company was set up but shortly afterwards had gifted them to her grandchildren. Dividends are paid.

(Emphasis added.) HMRC say:

> [S.629 ITTOIA] applies and attributes the dividends received by the children to Mr. J for tax purposes. Since Mr. J
> [1] is the person *responsible for making the company's profits* and
> [2] decides on the level of dividends paid,[67]
> it is Mr. J who is the settlor rather than the children's grandmother.
> The legislation could apply in a similar way if the children had subscribed for shares themselves with money received from a third party or even from bank accounts in their own names.

Suppose a stockbroker who is well disposed to the trust (perhaps a beneficiary) gives free investment advice to trustees to invest in quoted (easily obtainable) investments, and the trust profits from acting on his advice. There is an element of bounty but the stockbroker has not provided funds and is not the settlor. One cannot identify funds which would ordinarily have been received by the stockbroker. On the contrary, the stockbroker was free (if he had the resources) to make the same investments as those he recommended to the trustees. This is a clear case.

Suppose a property developer who is well disposed to the trust gives free property market advice to trustees, and the trustees invest in land

67 It is hard to see the relevance of [2].

successfully because of the advice. The developer has not provided property and is not the settlor. One cannot identify funds which would ordinarily have been received by him.

Suppose a director of a company held on trust seems reasonably well remunerated but HMRC argue that his remuneration is insufficient. Even if HMRC are right, the individual is not the settlor, because one cannot identify funds which would have been received by the director.

Mills and *Hawkins* were cases where it was intended from the outset that the settlor should provide services at an undervalue. In those cases the settlor contracted to provide services. In *Jones v Garnett*, it was likewise anticipated from the outset that Mr. Jones would provide his services at an undervalue. Here there was no contract, but that made no difference:

> It was the *expectation* of such events and the hope of profit which, together with the absence of any risk attached to the children's ownership of the shares, gives the "element of bounty" to the arrangement constituted by the allotment. What subsequently actually happened was not part of the arrangement.[68]

58.15.2 *Services not envisaged when settlement made*

What is the position if:

(1) a company is up and running and well established;
(2) an individual ("T") *subsequently* provides services at an undervalue (to benefit shareholders).

The question may arise in three circumstances:

(1) shares may be held by a spouse or minor children;
(2) shares may be held by a trust:
   (a) of which some other person is the settlor;
   (b) of which T is the settlor.

In case (1) there is (or may be) no settlement-arrangement before T begins to provide his services. The question is whether a settlement-arrangement

68 *Jones v Garnett* [2007] STC 1536 at [22]. Likewise Lord Walker at [50]: "A plan which existed when the structure was established."

comes into existence.

In case (2) there is a settlement already. The question in 2(a) is whether T becomes the settlor. In case 2(b) T is already the settlor. The question is whether he provides further property (which might taint the settlement).[69] Of course, all the questions are related and they come down to the same question: does T gratuitously provide property for the purposes of the settlement?[70] It is suggested that the answer is, strictly, yes, if one can identify the funds that T has provided: see above. But it appears that HMRC do not take the point. In *Jones v Garnett*, Lord Neuberger envisages a case (1) situation (share held by Mr and Mrs Jones but no settlement-arrangement):

> On that basis, I find it also very hard to see why Mr Jones's decision each year not to take anything like a full salary, thereby increasing substantially the dividend payable to his wife, does not involve an element of bounty. Neither [Counsel for HMRC] (no doubt reflecting the Revenue's policy) nor [Counsel for the taxpayer] (as it would involve his clients losing on this issue) was prepared to adopt this approach. Although it appears to me to be logically attractive, it would be inconvenient in practice, in that it would be difficult to administer, and it might well produce unfair, even arbitrary, results.[71]

58.15.3 *Services provided for full consideration*

In *Mills* in the Court of Appeal, Buckley LJ noted other circumstances why a person who provides services to a trust or company may not be providing property:

(1) A person does not provide funds for a settlement if:
  (a) he is entirely ignorant of the settlement (which would generally be the case for the employees of a company held by a trust), or
  (b) he does not have the view of advancing the interests of the trust.

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69 See 58.3.10 (Tainting).

70 See *Jones v Garnett* [2007] STC 1536 at [83]:

> "... the definition of settlement in [s.620 ITTOIA] and of the settlor in [s.620 ITTOIA] are closely connected, and it appears to me to be perfectly proper to rely upon observations as to what can be taken into account when considering who is a settlor, when deciding whether there is a settlement."

71 See *Jones v Garnett* [2007] STC 1536 at [89].

(2) A person does not provide funds for a settlement if he does so for reward in the ordinary course of his professional business.

No-one would suggest that these persons providing their services to the company or trust should be regarded as settlors and the only question is why not? It is suggested that the correct reason is because there is no element of bounty.

58.15.4 *What is the arrangement?*

In *Jones v Garnett* Mr. Jones worked for a company held equally by himself and his wife. Lord Hoffmann gave "settlement-arrangement" a somewhat limited meaning:

> [HMRC's] second argument is that the transfer of the share [to Mrs Jones] was not the whole of the arrangement, which included the provision of services by Mr Jones, the dividend policy and so forth. Again, I think that would be inconsistent with the argument by which the revenue have, in my opinion, succeeded on the first point. The transfer of the share was in my opinion the essence of the arrangement. The expectation of other future events [i.e. provision of services by Mr Jones] gave that transfer the necessary element of bounty but the events themselves did not form part of the arrangement.[72]

58.16 Interest-free or back-to-back loan

A person who lends interest-free (or on favourable terms) is in principle a settlor. HMRC agreed: SP 5/92 para 22 provides:

> A loan made, directly or indirectly to a relevant settlement after 19 March 1991 on non-commercial terms, eg at a low or nil rate of interest is regarded as a provision of funds for the purposes of TCGA 1992 Sch 5 para 9(3). This is the case whether the loan is for a fixed period or repayable on demand.[73]

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72 [2007] STC 1536 at [29]. Lord Walker said the same at [54] stressing the absence of a contract of employment.

73 SP 5/92 para 19-21 deal with the CGT implications of loans to trusts before 19 March 1991. This is not now important but is set out here for completeness:

> "19 A fixed-period loan made, directly or indirectly, to a relevant settlement prior to 19 March 1991 on non-commercial terms, eg at a low or nil rate of

Likewise Tax Bulletin 8 provides:

> Our view is that a person making a loan to the trustees on better than commercial terms is ... a settlor and transferor and within the provisions of [Chapter 5 Part 5 ITTOIA] or [s.727 ITA].

The same applies to a back-to-back loan. In *IRC v Wachtel*:

(1) the trustees borrowed from a bank, and
(2) an individual guaranteed the trustee loan and deposited funds equal to the trustee borrowing with the bank. The trustees paid only 1% interest on their loan.

The individual was rightly held to be a settlor.[74]

58.17 Indemnities

SP 5/92 provides:

> 34 An indemnity given by the new trustees to retiring trustees is not considered as the provision of funds for the purposes of the settlement under TCGA 1992 Sch 5 para 9(3).

This is right because there is no element of bounty. (Also the benefit of the indemnity is held by the *former* trustees so it is not property comprised in the settlement.)

> Other types of indemnity are considered in light of the facts of a particular case.

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interest is, generally, regarded as a provision of property in pursuance of a liability incurred before 19 March 1991, provided the loan remains outstanding on the same terms. As such, it falls within the terms of TCGA 1992 Sch 5 para 9(3)(b) and the first condition set out in para 9(3) is not met.

20 There would, however, be a direct or indirect provision of property for the purposes of the settlement where a fixed-period loan falls to be repaid after 18 March 1991 but repayment is not made and so becomes a repayable on demand loan.

21 An extra-statutory concession D41 ... sets out the position in the case of non-commercial, repayable on demand, loans for the purposes of applying TCGA 1992 Sch 5 para 9(3)."

74 46 TC 543 at p.555.

The standard form indemnity given by a beneficiary who receives trust capital is not the provision of funds, it is made in consideration of the trustees not exercising their trustee lien.

58.18 Guarantees

SP 5/92 continues:

> 35 The giving of a guarantee is regarded as an indirect provision of funds under the terms of TCGA 1992 Sch 5 para 9(3). Payment of an obligation under a guarantee given before 9 March 1991 is, in general, regarded as a payment in pursuance of a liability incurred before 19 March 1991 and within para 9(3)(b). This may not, however, apply where-
> - the contingent liability under the guarantee cannot be quantified with a sufficient degree of accuracy, eg where the guarantee is open-ended or the contingency is remote; or
> - the guarantor does not take reasonable steps to pursue his rights against the debtor.

58.19 Repayment of loan

SP 5/92 para 23 provides:

> The repayment of any loan made, directly or indirectly, to any person by the trustees is not generally regarded as the provision of funds for the purposes of the settlement under TCGA 1992 Sch 5 para 9(3). This does not, however, apply where
> [1] more is repaid than is due under the original terms of the loan or,
> [2] in the case of loans made after 19 March 1991, where the interest charged under the terms of the loan exceeds a commercial rate.

This is clearly correct (apart from point [2] but in practice that is not likely to arise). There is no element of bounty.

58.20 Sale or share issue at undervalue

A sale to a trust at a conscious undervalue is the provision of property and the seller is a settlor. Likewise a person is a settlor if he holds all the shares in a company and consents to the company issuing new shares to a trust at a conscious undervalue.[75] The TSE Manual correctly states at 4120 [January 2008]:

> ***Example 1***
> X is the director and owns all the 150 issued ordinary £1 shares of X Ltd. X Ltd issues 100 new ordinary £1 shares which are acquired for £100 by the X Family Trust. The trust has been established for the benefit of X's family by his father, X Senior, who created the trust by settling cash of £100. Shortly after the issue of the new shares, a dividend of £100 per share is declared and paid and the trust receives dividends of £10,000. X controlled the arrangement for the issue of the shares at par followed by the dividend. X is therefore the true settlor of the settlement from which income of £10,000 arose. The original settlement of £100 by X Senior is usually disregarded on de minimis grounds.

A sale at market value is not the provision of property. A bargain at arm's length (at a price regarded by both sides as market value) is not the provision of property even if the parties have mistaken the value and the property is sold at an undervalue.[76]

If values are uncertain the solution may be a market value adjustment clause. SP 5/92 provides:

> 13 Solely for the purposes of TCGA 1992 Sch 5 para 9(3)(a), a provision in the document governing the transaction for an appropriate adjustment to the consideration where the value agreed by the Revenue differs from the original consideration arrived at by an independent valuer and specified in the sale document is, in general, regarded as falling within the terms of the above definition of an arm's length transaction. The arm's length value of the transaction is to be determined in accordance with the principles set out in para 12 above. This will usually correspond to the value for capital gains tax purposes except, for example, where TCGA 1992 s 19 would apply.
> 14 It would also be necessary for the terms of the contract to provide for

75 This proposition is self evident but if authority is needed, see *Crossland v Hawkins* 39 TC 493 at pp.506–7.

76 This is consistent with the principles that a settlement-arrangement must have an element of bounty: see 58.2.3 (Settlement-arrangement), and that arm's length sales confer no "benefit": see 19.4.1 (Arm's length bargains).

compensating interest at a commercial rate to be paid in either direction once the arm's length value is determined. For this purpose, the official rate of interest for TA 1988 s 160 purposes will usually be regarded as equivalent to a commercial rate of interest, although a different rate may be accepted as so equivalent if the circumstances of a particular case warrant this treatment.

15 This practice is, however, subject to the consideration passing on sale being realistically based, ie on a third party valuation by a qualified valuer, all the other terms of the transaction being at arm's length and the compensating interest being timeously paid. The position in a particular case depends on all the facts and circumstances.

58.21 Failure to exercise right of reimbursement

SP 5/92 para 24 provides:

> [1] Failure, by or on behalf of any relevant person, to exercise statutory rights to reimbursement e.g. under [s.646 ITTOIA], may be regarded as the provision of funds for the purposes of the settlement under TCGA 1992 Sch 5 para 9(3).[77]

Point [1] only applies to a failure to exercise rights which is both deliberate and gratuitous (i.e. with an element of bounty). This is the reason for the exceptional case which para 24 then addresses:

> [2] The settlement could remain outside the terms of para 9(3) where

77 For completeness, Tax Bulletin 8 correctly qualifies this:

> "Para 24 of the Statement of Practice [5/92] points out that failure to exercise statutory rights to reimbursement against non-resident trustees may be regarded as the provision of funds for the purposes of the settlement under para 9(3) of Schedule 5, TCGA 1992. This will not, however, apply in respect of a settlor's non-exercise of statutory rights to reimbursement out of the trust income account where the settlor has a life interest in all the assets of the trust. In such circumstances, failure to exercise the right to reimbursement would, effectively, not add funds to the trust since all income would, in any ease, either be paid to the settlor under the terms of the trust deed or be used to meet expenses chargeable against income.
>
> But even in such cases the settlor may have rights to reimbursement out of the trust capital account, eg in relation to accrued income charges, which if not exercised will be regarded as the provision of funds."

For other issues relating to reimbursement, see 1 (Reimbursement of tax under statutory indemnity) and 677 (Relevant income used to pay expenses)

> the exercise of the right to reimbursement is unsuccessful, provided it could be shown that there had been a genuine attempt to enforce rights to reimbursement.

The exception is stingily worded (here as in several other points, SP 5/92 gives the impression that it was intended to make life as difficult as possible for offshore trusts). It is not strictly necessary to show "a genuine attempt to enforce rights to reimbursement". It is sufficient to show that such rights are not enforceable.

58.22 Payment of administrative expenses

SP 5/92 provides two cases where payment of capital expenses and of a life tenant's income does not make the life tenant a settlor:

> 29 An expense on capital account paid out of trust income is not treated as a provision of income by a beneficiary for the purposes of TCGA 1992 Sch 5 para 9(3) provided that either—
> [1] the trust deed permits payment of capital expenses from income and the beneficiary is entitled only to net income after such payments;[78] or
> [2] the trustees borrow money from the income account which is subsequently restored, along with interest over the period of the loan. The appropriate rate of interest is considered to be that which a Court of Equity would order on the replacement of trust income.[79]

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78 For completeness, Tax Bulletin 8 expands on this:

> "Para 29 of the Statement of Practice concerns, inter alia, trust deeds which permit capital expenses to be paid out of the income account. Neither the existence nor the exercise of this power would cause the trust to lose an interest in possession status for IHT purposes."

79 For completeness, Tax Bulletin 8 expands on this:

> "Where there is no such power, para 29 states that capital expenses may nevertheless be met out of income without the condition in para 9(3), Schedule 5, TCGA 1992 being met; provided that the income account is subsequently restored, along with appropriate interest over the period of the loan. The appropriate rate of interest is considered to be equal to the rate payable on the Basic Account administered by the Court Office of the Supreme Courts of Justice. Such interest will constitute taxable income in the hands of the income beneficiary (either when it is credited in the case of a life tenant, or when it is paid or applied for the benefit of a discretionary beneficiary). It may also be treated as "relevant income" for [s.731 ITA] purposes.
> Income beneficiaries will only be liable on the net amount of income available

One question, more analytically, is whether the life tenant has provided intentional and gratuitous benefit to the trust. Clearly, in the two cases mentioned, the life tenant does not do this and so does not become a settlor. Since trusts generally do allow capital expenses to be paid out of income, the issue mainly arises when a trust has no income and someone (typically a beneficiary) needs to pay the expenses. In this case there may also be no gratuitous element. It is in the beneficiary's interest to make the payment. Subject to that, the SP tacitly answers that the intentional and gratuitous payment of trustees' expenses *does* make the payor a settlor. But this is not correct. Firstly, in some cases, the payment of expenses may be a provision of services to the trust rather than the provision of property.[80] Secondly, "no property of which S is the settlor" is comprised in the settlement, so under s.469 ITA the payor of expenses is not the settlor.[81]

58.23 Trust retains life tenant's income

SP 5/92 para 33 provides:

> A life tenant is not regarded as having provided income or property for the purposes of the settlement merely because there is an administrative delay in paying out the income that has vested in that beneficiary. If, however, the beneficiary directs the trustees to retain this income on the terms of the settlement, this is regarded as a provision of funds within TCGA 1992 Sch 5 para 9(3).

This is fairly obvious.

58.24 Purpose: minor settlor

In *Mills v IRC* 49 TC 367, the funds of the settlement were derived from

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after deduction of any income which has been applied to meet expenses on capital account. Only when the income account is made good will that income become taxable on the beneficiary."

80 See 58.15 (Provision of services).

81 See 58.3.2 (The standard IT/CGT definition of settlor).

acting work of Hayley Mills, then aged 14. She was supposedly[82] unaware of the settlement to which at her direction her earnings were paid. The argument was that she had not provided funds for the *purpose* of the settlement. Viscount Dilhorne said:

> [1] I do not agree with Lord Denning MR that the word "purpose" in this section connotes a mental element or with Buckley LJ that there must be a motivating intention. I do not myself think that it assists to consider whether the question he posed is to be answered objectively or subjectively. I do not consider it incumbent, in order to establish that a person is a settlor as having provided funds for the purpose of a settlement, to show that there was any element of mens rea.
> [2] Where it is shown that funds have been provided for a settlement a very strong inference is to be drawn that they were provided for that purpose,
> [3] an inference which will be rebutted if it is established that they were provided for another purpose.

It is difficult to see what point this sloppy passage is trying to make.[83] It is not that purpose is irrelevant: see [3]. That seems to contradict the sentence at [1], but it is obviously right. "Purpose" and "provide" inescapably connote a mental element. The best explanation of this passage is that it is considering the situation like the facts in *Mills* where Hayley Mills *did* intend to provide funds for the purpose of her trust (as shown by her signing a contract which had that effect) but she took almost no interest in the matter. That is, the comment is restricted to the facts of that particular case.

The legislation sometimes refers to purpose of the settlement (in the

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82 The actual evidence recorded that she was "not very interested", which is not the same. The case should have been decided on the simple factual basis that Hayley Mills *did* intend to provide funds for the purpose of the settlement, even if she did not trouble to think very much about it. The judge made this point at p.378:

> "The case was put on a factual assumption that Hayley Mills did not subjectively intend to provide funds. This was factually incorrect, and not even conceivable, because it was completely inconsistent with the view that the contract she signed was valid. If Hayley had not thought about it at all, the contract which she signed would be void under the rule *non est factum*."

83 Dilhorne, who took a third in law, was "not in the highest flight of English lawyers" (DNB).

singular) and sometimes purposes (in the plural) but there is no distinction.[84]

58.25 Purpose: advisers and agents of settlor[85]

It is considered that in ascertaining purpose one may have regard not only to the mind of the settlor, but also the mind of those acting for him or her. Agency principles may be applied. See *Crossland v Hawkins* 39 TC 439 at p.508:

> The mere fact that he did not concern himself with some of the 'steps' in the legal machinery involved does not make it any the less his arrangement within the section. A man does not avoid the incidence of section 397 [now s.629 ITTOIA (income paid to unmarried minor children of settlor)] by merely being absent from and leaving to his solicitors and accountants certain parts of the legal machinery if he is aware of the proposals for an 'arrangement' or a settlement and actively forwards them by personally carrying out and assisting in the vital parts in which his performance and co-operation are necessary. Nor can he avoid liability by merely giving his solicitors carte blanche to effect some scheme for the benefit of his family and refusing to concern himself with its precise form.

On this analysis many apparent difficulties fall away.

In *Mills*, the father acted on behalf of the daughter.[86] The purpose of the father was to provide the daughter's funds for the purpose of the settlement. That suffices to make the daughter the settlor if she had no purpose of her own. Likewise in *Hatton*[87] the purposes of Mrs Cole's attorney was to provide funds for the settlement, and this purpose should be regarded as the purpose of Mrs Cole.

58.26 Settlement made by court for person lacking capacity

The court has power to make a settlement for a person lacking capacity

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84 "The statute seems to me to use the word 'purpose' and 'purposes' indiscriminately"; *Crossland v Hawkins* 39 TC 493 at 507.

85 See 21.15 (Purpose: advisers and agents of transferor).

86 See 49 TC 367 at pp.382 and 385.

87 See 58.4 (Gift from A to B followed by gift to trust by B).

"on his behalf". It is considered that the person lacking capacity is the settlor.[88] The Court of Protection agree:

> Trusts set up by an order of the Court of Protection will take the form of a settlement, with the patient being the settlor. ... in the case of trusts set up by an order of the Court of Protection, provision can be made for income to be accumulated, if appropriate, for the lifetime of the patient as section 164(1)(a) Law of Property Act 1925 applies.[89]

58.27 Settlement made by compromise of claim of minor or person lacking capacity

Parties to litigation may make a settlement under a compromise on behalf of a claimant who is a minor or person lacking capacity.[90] The Court of Protection say:

> An award of damages can be settled, by consent, in trust for the patient as part of the terms of compromise of the action between the plaintiff and the defendant, with the approval of the High Court, in circumstances where the award never becomes the absolute property of the patient.
> Trusts set up following an order of the High Court can only be done in the form of a declaration of trust by the trustees ... . The period over which income can be accumulated by the trustees is restricted to 21 years.[91]

This assumes that the minor/mental patient is not a settlor for trust law purposes. The first sentence (which is probably the basis for the conclusion) is unsound. While the *award* never becomes the absolute property of the patient, the award represents the claim, which is the property of the claimant.[92]

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88 Sections 16, 18(h) Mental Capacity Act 2005. The tax position is the same for settlements made under the Mental Health Act 1983.

89 Court of Protection Practice Note, 15 November 1996, para 4.

90 See *Drafting Trusts & Will Trusts*, James Kessler QC, 8th ed., Chapter 23 (Trusts of damages).

91 Court of Protection Practice Note on the settlement of personal injury awards to patients, 15 November 1996, paras 2 and 4; set out in the White Book (Civil Procedure) para 6B-119.

92 *Zim Properties v Proctor* 58 TC 371.

But HMRC accept in practice that there is no settlor.[93] It would follow that the trust fund is excluded property, e.g. if it is an AUT, an OEIC, or not UK situate.

58.28 Trust under Criminal Injuries Compensation Scheme

An award under the Criminal Injuries Compensation Scheme may be transferred to a trust.[94] The applicant under the Criminal Injuries Compensation Scheme is not the settlor of such a trust.[95] That is consistent with the position under the VTA. However, HMRC have apparently expressed the view that the claimant is the settlor, and in practice this view may well favour the taxpayer (as s.624 ITTOIA reduces the IT charge if the settlor is not a higher rate taxpayer).

58.29 Trust made in divorce settlement

In *Harvey v Sivyer* 58 TC 569 a separated husband made payments to his minor children under a deed of separation. The payments were not voluntary; they were pursuant to an obligation to maintain the children and contained no element of bounty.[96] The taxpayer argued that for this reason that there was no "settlement" within the settlement-arrangement definition. The argument was rejected and the taxpayer was held to be the settlor. The judge tentatively reconciled his decision with the bounty requirement because "the natural relationship between parent and young child was one of such deep affection and concern that there must always be an element of bounty by the parent, even when the provision is on the

93 Private correspondence.

94 Para 50 Criminal Injuries Compensation Scheme 2001.

95 The drafter of Part 2 Chapter 4 FA 2005 assumed this, though one needs to dig a little into the provisions to see why this is so:
(1) CICS trusts are within the provisions: s. 35 FA 2005.
(2) Settlor-interested trusts are outside the scope of the provisions: see s.25(3) and 30 FA 2005. (In relation to CGT this was clearer before s. 77 TCGA was repealed in 2008).
(3) The claimant under the CICS would always be a beneficiary, so if he was the settlor the trust would be settlor-interested.
So the drafter must have assumed that the claimant was not the settlor, or the provisions made no sense.

96 58 TC 569 at p.572.

face of things made under compulsion".[97] This is romantic nonsense, as any family lawyer will attest. The better way to justify the decision is to note that the bounty requirement is not statutory, and not to be applied unthinkingly. The Court of Appeal noted in an earlier case, "if the legislature had set limit to the extent to which a taxpayer may divest himself for tax purposes of income by voluntary means, I see no reason why the same principle should not be applied to income of which the taxpayer is compulsorarily divested".[98] So this is simply an exception to the bounty requirement. On this analysis, *Harvey v Sivyer* was correctly decided, though not for the right reasons.

58.30 Trust made by instrument of variation

58.30.1 *The usual situation*

Suppose:

(1) B inherits property absolutely from the estate of a deceased, D.
(2) B varies the will so as to create a settlement of that property; and s.142 IHTA and s.62 TCGA apply.

B is clearly the settlor in the general sense: see 58.4 (Gift from A to B followed by gift to trust by B).

58.30.2 *Settlor for IHT*

For inheritance tax purposes, the effect of s.142 IHTA is probably to override the general sense; the settlor is D and not B. HMRC accept this. (The contrary view is arguable but it will not usually be in the taxpayer's interest to argue it.) IHT Manual provides:

> **35151 - IHT implications of an Instrument of Variation: effect of coming within s.142**
> When a variation satisfies the requirements of s.142(1) IHTA and there is a valid election or, on or after 1 August 2002, a valid statement of intent

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97 58 TC at p.577.
98 *Yates v Starkey* 32 TC 38 at p.53.

- the variation is not a transfer of value, and
- the IHTA applies as if the deceased had effected the variation

Consequently, for example ...

[1] if a variation sets up a non-interest in possession trust, the deceased is treated as the settlor, and

[2] the GWR rules in s.102 FA 1986 cannot apply to a disposition which is accepted as a variation within s.142(1) IHTA.

This is because the effect of s.142(1) IHTA is that the deceased is treated as the donor.

Point [1] states that the deceased is the settlor if a variation sets up a non-interest in possession trust. The same rule must in principle apply if the variation sets up an interest in possession trust (but with the added complication of the s.80 IHTA rules, if applicable). Likewise Tax Bulletin 15 provides:

> Our view is that, as the relevant IHT legislation differs from the CGT provisions which were considered in *Marshall v Kerr*, that decision has no application to IHT. Variations which meet all the statutory conditions will continue to be treated for IHT purposes as having been made by the deceased.

58.30.3 *Settlor for IT: variations before 6 April 2006*

B is the settlor for IT purposes in the case of variations made before 6 April 2006.

58.30.4 *Settlor for CGT: variations before 6 April 2006*

The identity of the settlor for CGT is an unresolved question.[99] The issue is whether s.62 TCGA overrides the general sense of settlor. The House of Lords held in *Marshall v Kerr* 67 TC 56 that for CGT the settlor is the beneficiary making the variation, not the testator. However, the reasoning relies entirely on the fact that the beneficiary settled a share in an unadministered estate. The position is therefore different if:

(1) the IOV is made after administration of the estate has been completed; or

99 See "*Marshall v Kerr* Revisited", *Taxation*, 3 May 2001 (Christopher Sokol QC).

(2) the will or intestacy is governed by the law of a jurisdiction (such as a civil law jurisdiction) which (unlike common law jurisdictions) does not recognise personal representatives and an administration period; or
(3) the disposition varied is a joint tenancy (because, as in (2), there is no administration period in respect of property passing by survivorship).

In the following discussion cases (1) to (3) above are called "non-administration" cases, and cases where the estate was in administration (like *Marshall v Kerr*) are called "administration cases".

The reasoning of the House of Lords suggests that the law is as follows:

(1) In administration cases; if the IOV is made before 31 July 1978 (the passing of the FA 1978) the beneficiary is the settlor: that, at least, is clear from *Marshall v Kerr*.
(2) In non-administration cases whenever the IOV is made, it is considered that the deceased is the settlor.
(3) In administration cases after 31 July 1978, it is suggested that the deceased is the settlor. *Marshall v Kerr* has been reversed by (what is now) s.62(9) TCGA: this subsection was not in force in the tax years relevant to *Marshall v Kerr*.

To distinguish between administration and non-administration cases is highly anomalous, so this view of s.62(9) TCGA brings welcome consistency into the law. It also brings CGT into line with IHT.

It appears to be the HMRC view that the beneficiary is the settlor even in cases (2) and (3). CG Manual 37888 [August 2007] provides:

> The Revenue had always considered that Section 62(7) was concerned with computational matters only, and had no effect on the question whether a new settlement had come into existence or the identity of the settlor. The majority of the House of Lords, in Marshall v Kerr, 67TC56, preferred slightly different reasoning in holding that a residuary legatee, who had executed an instrument of variation so that her 50 per cent share of the estate was settled, was the settlor for the purposes of Section 87 TCGA 1992 (charge on beneficiaries of non-resident settlements). It may be noted that the case was concerned with the pre-1978 version of the relevant legislation and it is considered that the Revenue's arguments in that case are stronger under the later legislation.

> Where the instrument was executed before 6 April 2006 this decision should be applied for the purposes of Section 77 TCGA 1992 & Section 86 TCGA 1992 (charge on settlors of certain settlements) and TCGA 1992/SCH1 (annual exempt amount for trustees).
> Where the instrument was executed on or after 6 April 2006 and notice is given under Section 62(7) Section 68C TCGA 1992 applies with these consequences.
>
> - Where under the will or intestacy property was to pass absolutely to an individual, and a variation is executed settling that property (or property deriving from that property), then the person to whom the property would have passed is the settlor with regard to that property.
> - Where under the will or intestacy property was to be settled, but the variation is such that a new settlement is created (see CG37887) then the deceased is the settlor.
> - Where under the will or intestacy property was to be settled, but the variation is minor, then the deceased would be the settlor without the new legislation in FA 2006 and therefore this case is not provided for specifically.[100]

The author has been expecting further litigation on this aspect since 1994, but it has not happened yet. In view of the 2006 reforms, HMRC may not dispute the position for variations before 6 April 2006.

58.31 IT and CGT – IoVs from 6 April 2006

Section 472 ITA provides:[101]

> (1) This section applies if—
> (a) a disposition of property following a person's death is varied, and
> (b) section 62(6) of TCGA 1992 applies in relation to the variation.
> (2) [i]If property becomes settled property because of the variation
> [ii] and would not, but for the variation, have become settled property),

100 Likewise TSEM 1815 [January 2008]:
"The settlor of a trust created by a deed is not the deceased, unless it's a disclaimer (TSEM1840). It is the person who was entitled to the gift that has now gone into trust. The gift can be capital or income or both. The case of *Marshall v Kerr* (67 TC 56) is relevant. There may be more than one settlor."

101 The CGT equivalent is s.68C TCGA.

a person within subsection (3) is treated for the purposes of the Income Tax Acts (except where the context otherwise requires)—
(a) as having made the settlement, and
(b) as having provided the property for the purposes of the settlement.
(3) The persons within this subsection are—
(a) a person who immediately before the variation was entitled to the property, or to property from which it derived, absolutely as legatee,[102]
(b) a person who immediately before the variation would have been so entitled if that person had not been an infant or otherwise lacking legal capacity,
(c) a person who, but for the variation, would have become so entitled, and
(d) a person who, but for the variation, would have become so entitled if that person had not been an infant or otherwise lacking legal capacity.

Section 472 (and its CGT equivalent, s.68C TCGA) applies in the usual situation, where a beneficiary absolutely entitled to property under a will varies the will so as to create a settlement. Section 68C TCGA enacts the HMRC view that the beneficiary is the settlor for CGT. Section 472 confirms (which no-one ever doubted) that the beneficiary is the settlor for IT.

This applies not just for the standard IT/CGT definition, but for all purposes of IT and CGT. Although the drafter adds the words except "where the context otherwise requires", I cannot think of a case where the context would "otherwise require"; and I expect the drafter has copied

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102 Section 472 provides:
"(4) For the purposes of subsection (3)—
(a) "legatee" includes a person taking property—
(i) under a testamentary disposition or on an intestacy or partial intestacy, whether beneficially or as trustee, or
(ii) under a donatio mortis causa, and
(b) a person who is a legatee as a result of para (a)(ii) is treated as acquiring the property when the donor dies.
(5) For the purposes of subsection (4)(a) property taken under a testamentary disposition or on an intestacy or partial intestacy includes any property appropriated by the personal representatives in or towards satisfaction of—
(a) a pecuniary legacy, or
(b) any other interest or share in the property devolving under the disposition or intestacy."

without much thought the wording used (appropriately) in s.467 ITA.

Section 473 ITA provides:

> (1) This section applies if—
> (a) a disposition of property following the death of a person ("D") is varied, and
> (b) section 62(6) of TCGA 1992 applies in relation to the variation.
> (2) If—
> (a) property would have become comprised in a settlement within subsection (3), but
> (b) as a result of the variation, the property, or property derived from it becomes comprised in another settlement,
> D is treated for the purposes of the Income Tax Acts (except where the context otherwise requires) as having made the other settlement.
> (3) A settlement is within this subsection if—
> (a) it arose on D's death (whether by D's will or on D's intestacy or in any other way), or
> (b) it was in existence immediately before D's death (whether or not D was a settlor in relation to it).
> (4) If—
> (a) immediately before the variation property is comprised in a settlement and is property of which D is a settlor, and
> (b) immediately after the variation the property, or property derived from it, becomes comprised in another settlement,
> D is treated for the purposes of the Income Tax Acts (except where the context otherwise requires) as having made the other settlement.
> (5) A settlement treated as made by D as a result of this section is treated for the purposes of the Income Tax Acts as made by D immediately before D's death.
> (6) But subsection (5) does not apply in relation to a settlement which arose on D's death.

Section 473 applies in the highly unusual situation where property settled by will is re-settled by beneficiaries.[103] Here the opposite rule is enacted: the beneficiaries are *not* settlors for IT or CGT.

Where s.472 applies, s.472(2) imposes two rules:

(a) the beneficiary ("B") is deemed to have made the settlement;
(b) B is deemed to have provided the property for the purposes of the

103 See 58.10 (Variation or resettlement by beneficiaries).

settlement.

By contrast, where s.473 applies, we only have rule (a): the deceased is deemed to have made the settlement. By implication, rule (b) must also apply: the deceased must be deemed to have provided the property.

58.31.1 *Commentary*

What is the reason for s.473? Perhaps because it can be hard to identify settlors on variations of settlements. Perhaps because, if the will actually settled the property, there is little need or scope for tax planning by IOVs. In practice s.473 is not important. It appears to be dead letter tax law (not the only dead letter tax law enacted as a result of the provisions that passed under the banner of trust modernisation). Does it matter to have on the statute book complex provisions that never apply and no-one need take notice of? I think it does, and maybe some day some reformer will sweep it away, and bring CGT and IHT into alignment. The IHT rule is a sensible one, for it fits the object of the IOV rules, which is to allow beneficiaries to avoid the tax unfairnesses of badly drafted wills.

58.32 Pension trusts and employee trusts

58.32.1 *Is a pension or employee trust a settlement?*

It is possible (albeit unusual) that a trust is made with no element of bounty. This is here called a commercial trust. An example is an employee trust made by the employer for commercial reasons. The position is as follows:

(1) A commercial trust is a classic settlement.
(2) A commercial trust is not a settlement-arrangement.

HMRC accept this. CG Manual 14596 provides:

> **Pension funds**
> ... It is considered that for the purposes of Income Tax a pension fund, certainly an approved one, is not a settlement, because of the absence of 'bounty'; (see *Berry v Warnett*, 55 TC 92 for a discussion of the bounty test). Accordingly transfers of assets to Pension Funds are not connected persons transactions and there is no restriction of availability

of losses under section 18(3) TCGA 1992.

58.32.2 *Who is the settlor of a commercial trust?*

The position is as follows:

(1) "Providing" property requires an element of bounty, and no-one can be said to "provide" property to a commercial trust.
(2) To make or enter into a settlement does not require an element of bounty, so a commercial trust may have a settlor in that sense.

CG Manual 33240 [June 2003] provides:

> Because a person who has 'made' or 'entered into' a settlement is within the definition of settlor it is not considered necessary for 'bounty' to have been provided. Therefore employee trusts have a settlor. See CG33580 and CG35020+.

The argument is valid for the standard IT/CGT definition, the settlement-arrangement definition, and the IHT definitions of "settlor". These definitions use the words "made" or "entered into". The argument does not run for the CGT s.86 definition.[104] HMRC accept this. CG Manual 34804 [August 2007] provides:

> Companies frequently create settlements. These are generally settlements for employees, see CG35020, or other commercial arrangements, see CG35023. Such settlements are usually excluded from TCGA Section 77 because of the bounty test.

A commercial settlement was in fact a settlement for the purposes of the former s.77 but s.77 did not apply because the company was not within the s.77 definition of settlor.

The CG Manual continues:

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104 The Revenue Booklet "The tax treatment of Top-Up Pension Schemes", para 2.7.5, provides:

> "The 'benefit to settlor' rules in [s.626 ITTOIA and s.77 TCGA] can apply to top-up pension schemes. But this is not likely to be the case where the structure and operation of a scheme are broadly similar to an approved pension scheme."

> Exceptionally it may be appropriate to argue that TCGA Section 77 applies to the particular settlement. Although there is no specific provision comparable to TCGA Schedule 5 Para 8(4), nevertheless it may be appropriate in such a case to consider whether the property entering the settlement has been provided indirectly by the shareholders, both for the purposes of TCGA Section 77 and for the purposes of [s.624 ITTOIA].

Likewise, CG Manual para 35020 states in relation to unapproved pension schemes:

> ... it can also be argued that the employees themselves are also settlors.

58.33 Trust made by company

Section 624 ITTOIA(clearly) and s.86 TCGA (probably) do not apply to a company even if it does create a settlement and is the settlor. The context suggests that only individuals are intended to be caught. HMRC do not accept this for CGT.[105] The issue rarely arises because of the bounty requirement to be a settlor. Where a company makes a settlement, however, the individual controlling shareholder(s) may be settlor(s) because they provide property indirectly.[106]

58.34 Planning to create trust with foreign domiciled settlor

The "who is the settlor" question may arise in a tax planning context where it is desired to create a foreign domiciled trust by transferring property to a foreign domiciled settlor. These arrangements are always challenging and sometimes impossible to carry out in practice, for it depends ultimately on intention, and that cannot be manufactured to suit

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105 The CG Manual provides:

> "**35020. Trusts for employees**
> There is nothing in Section 77 [TCGA] itself to prevent it being applied to a company. In particular, where a company has set up a settlement for its employees, the deed may provide that if all the trusts fail, the property may revert to the company. The most common cases are share option schemes and unapproved pension schemes."

The point cannot be considered here. See *Taxation of Charities*, Kessler & Kamal, Key Haven Publications, 6th ed, para 17.2.2 (Corporate lender).

106 Contrast 18.3.2 (Transfer procured by individual).

the circumstances.

Example 1

(1) H (UK domiciled) gives property to his wife W (not UK domiciled); and
(2) W gives it to a trust.

Who is the settlor: H or W or both?

The success of schemes involving a transfer to a foreign domiciliary who creates a settlement depends on how the transaction is carried out. Does W have a genuine and wholly independent role?[107] It is suggested that W should retain the property for at least one year; that no decision be made as to whether or not to create a settlement at the time of the gift from H to W; *a fortiori* no decision should be made on the terms of the trust; and W should receive independent legal[108] advice on any proposed gift to a settlement.

Example 2

(1) Trustees of a trust (with a UK domiciled settlor) appoint property to a beneficiary ("B") (not UK domiciled); and
(2) B gives the property to a new trust.

In principle, the settlor of the new trust will be B, not the settlor of the old trust.[109] But it is different if B is acting at the behest of the settlor.[110]

Watch the trust law rule of fraud on a power, and *Furniss v Dawson*. It would be better if the terms of the new settlement are different from the terms of the old. For an (almost unbelievable) example of botched execution of this scheme, see *Anker-Petersen v Christensen* [2002] WTLR 313.

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107 See 58.4 (Gift from A to B followed by gift to trust by B).

108 W may also need tax advice, but what matters here is that W has independent advice on the property law aspects of the gift.

109 See 58.6 (Appointment from old trust to B followed by gift to new trust by B).

110 See 58.5 (Trust created by B at request of A).

CHAPTER FIFTY NINE

SITUS OF ASSETS FOR IHT

59.1 Concepts of situs

Situs[1] of assets is relevant for many tax and non-tax purposes of which the most important are:

(1) IHT excluded property rules; and
(2) the CGT remittance basis.

Situs (like domicile) is in origin a concept of private international law (or conflict of law) which has been adopted for tax purposes. The rules are laid down by the common law. The common law rules apply for tax, except so far as modified by specific rules in tax legislation.

IHT situs is almost entirely based on the common law rules. These are discussed in this chapter. Some IHT double tax treaties override the usual IHT situs rules.[2]

CGT has statutory situs rules which cover most situations, and the common law is only needed to fill in a few gaps. So CGT situs is best regarded as a separate subject, even though in a few cases the common law/IHT principles still apply for CGT. Situs for CGT is discussed in the next chapter.

The income tax source rules are different from situs.[3] Situs only occasionally matters for IT, but where it does, the common law rules

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1 A note on terminology. The IHTA and TCGA generally refer to the "situation" of assets though the heading to s.275 TCGA refers to "location". One sometimes sees "local situation". The concept in each case is the same. "Situs" has become adopted into legal English usage and should not be written in italics.

2 See 50.5 (Treaty situs rules).

3 See 11.4 (Why does situs of source matter?).

discussed in this chapter will apply.

The situs of land and chattels seems obvious (but occasionally the law does not adopt the obvious solution). For intangible assets (shares, debts, etc.), the law must choose connecting factors to link the asset to a jurisdiction. There is a large choice of possible connecting factors, and the selection of the determining factor must sometimes be arbitrary.[4] One might think that it would not matter much what the rule was, as long as there is some rule and its application is clear. But the desirable rule (at least from the HMRC viewpoint) is one which minimises the scope for tax planning. The common law rules do not achieve that, and so this is an area of law with many anomalies. The common law situs rules are not well suited to serve as a territorial limitation for tax. It is not surprising that common law situs no longer has the role it once had in private international law, and very few of the common law rules apply to CGT.

59.2 Every asset has one situs

Under the common law rules,[5] every asset is situate in one jurisdiction[6] and only in one jurisdiction. In *R v Williams* [1942] AC 541 at 559 the Privy Council said:

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4 In *R v Williams* [1942] AC 549 the Privy Council said:

> Shares in a company are "things in action" which have in a sense no real situs, but it is now settled law that for the purposes of taxation ... they must be treated as having a situs which may be merely of a fictional nature.

In *New York Life Insurance v Public Trustee* [1924] 2 Ch 101 the situs rules were described as "legal fictions". It is of course true that an asset with no corporeal existence, such as a debt or other chose in action, has no material position in the material world. Nevertheless a better analysis is to say that "situs" (of a chose in action) is a metaphorical term describing an abstract concept. The situs of a chose in action is not "fictional", but perfectly "real" (or at least as real as concepts such as "residence" or "domicile" or indeed "chose in action") though the concept may be described as "technical" or (if one prefers a pejorative term) "artificial". Lawyers are entitled to use ordinary words in special senses and to call a situs (of a chose in action) a "fiction" is misleading and inappropriate. See J.H. Baker, *The Law's Two Bodies*, OUP, 2001 lecture 2 ("Legal Fictions"); Neil MacCormick, *Institutions of Law*, 2007, p.1136.

5 This rule can be altered by statute, and for CGT it has been, but only in minor respects: see 60.22 (Intellectual property).

6 *English Scottish and Australian Bank v IRC* [1932] AC 238.

> Property, whether movable or immovable, can ...[7] have only one local situation.[8]

This rule is self evidently necessary since the purpose of situs rules in private international law is to resolve conflicts of jurisdiction, and one purpose in tax is to avoid double taxation. It is also implicit in the word situs: the physical fact that a physical object (above the level of quantum physics) can be situate in only one place. I stress this as some old cases considered assets could be dual situate. They no longer represent the law.

59.3 Situs of shares: general principle

In *Brassard v Smith* [1925] AC 371 the Privy Council said:

> This is, in their Lordships' opinion, the true test. Where could the shares be effectively dealt with?

In *R v Williams* [1942] AC 541, the Privy Council approved this passage and said:

> It may be useful here to make some general remarks on the meaning and effect of the principle laid down in *Brassard v Smith* and in the *Erie Beach* case. The first observation is that the phrase used in laying down the principle clearly means "where the shares can be effectively dealt with as between the shareholder and the company, so that the transferee will become legally entitled to all the rights of a member," e.g., the right of attending meetings and voting and of receiving dividends. If the phrase only meant "effectively dealt with as between transferor and transferee of shares," the test would obviously be almost completely useless, since the rights of a shareholder as between himself and a transferee can, speaking generally, effectively be transferred in any part of the world.

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7 The omitted words are "... for the purposes of determining situs as among the different provinces of Canada in relation to the incidence of a tax imposed by a provincial law upon property transmitted owing to death". These words do not qualify the general principle as there is only one common law situs concept and (subject to statute) that applies for all purposes.

8 Likewise *Laidlay v Lord Advocate* (1890) 15 App Cas 468 at p.483: "locality cannot be both England and India—the choice has to be made between the two".

These cases concerned registered shares, but the comments (cited in the IHT Manual at 27122) are not so restricted and apply to bearer shares also.

The question which follows from this test is: How to identify the place where shares can be dealt with?

59.4 Situs of registered shares

59.4.1 *Place-of-register rule*[9]

The IHT Manual provides:

> **27121 Inscribed[10] and registered securities:[11] usual location**
> For the purposes of Inheritance Tax an inscribed and registered security (a shareholding in a Company for example) is located at the place where the title of ownership must be registered – see *Att Gen v Higgins*.[12]
> However, some international securities have different rules (IHTM27078).
> It makes no difference that the business of the company is totally administered outside the country in which the register is kept: see *Baelz v Public Trustee* [1926] Ch 863.

I refer to this as "**the place-of-register rule**".[13] This is a straightforward application of the general principle that shares are situate where they can be dealt with.

It is necessary for completeness to mention *Macmillan v Bishopsgate Trust (No. 3)* [1996] 1 WLR 387. This concerned a company incorporated and with its share register in New York. Auld LJ adopted the place-of-register rule: see p.411E. Alarmingly, Aldous LJ stated without discussion that the situs is the place of incorporation: p.423F. Staughton LJ inclined to the same view but expressed himself more cautiously: p.405E. However, this was a case where the court did not have to decide between place-of-register rule and the place of incorporation as rival situs

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9 See "The Situs of Registered Shares", Robert Venables QC, PTPR Vol 9 p.115.

10 "Inscribed" securities are those whose legal owners are inscribed in a register; the term is, as far as I can see, only an old-fashioned synonym of "registered".

11 "Securities" here includes shares as well as debt securities.

12 (1857) 2 H & N 339 accessible on *www.kessler.co.uk*. This was approved in *AG v Winans (No. 2)* [1910] AC 27.

13 A "register" is only a record of stockholders and their assignees: see *Ramsay v IRC* 54 TC 101 at p.133.

rules. The court's attention was not on the point and the relevant cases were not discussed. In the circumstances, it is suggested that no weight whatever should be given to these dicta. HMRC Manuals tactfully ignore this case. It is a pity that the majority of the Court of Appeal did not express themselves more carefully or more cautiously; they have introduced into the law if not an uncertainty at least an inconsistency which needs to be explained away. But there it is.

59.4.2 *Overseas branch registers*

Multiple registers raise a problem for a place-of-register rule. If there is only one register applicable to the shares in question, that is where the shares can be dealt with. The IHT Manual provides:

> **27122 Inscribed and registered securities: branch registers**
> If a company has more than one register, and any changes must be recorded on one of the registers, the relevant securities are situate in the place where that register is required by law to be kept – not in the place of the head office of the company.

This requires an examination of company law to identify which of the two registers is applicable. The IHT Manual summarises the background company law:

> **27124 - Inscribed and registered securities: overseas branch registers of UK companies**
> Under UK law a share cannot, at one and the same time, be registered on more than one register.
> The rule applies even as regards overseas branch registers (these are branch registers of members resident in the country to which the register relates). Under [s.132 CA 2006], a company that maintains an overseas branch register has to keep a duplicate thereof at the place where its principal register is kept.
> And "no transaction with respect to any shares registered in an overseas branch register shall, during continuance of the registration, be registered in any other register" – see [s.133 CA 2006].
> Shares on the overseas branch register of a UK company are therefore situated, for Inheritance Tax purposes, in the country where the register is kept.
> Under [s.129 CA 2006] a company may maintain an overseas branch register. The countries and territories in which overseas branch registers

may be kept are specified in [s.129 CA 2006]. [S.129 CA 2006] enable[s] the provisions as to overseas branch registers to be extended by Order in Council to countries within the jurisdiction, or under the protection, of the Crown.

This view is confirmed by s.133(3) CA 2006:

> An instrument of transfer of a share registered in an overseas branch register—
>
> (a) is regarded as a transfer of property situated outside the UK.

59.4.3 *Transfer office*

Another solution may be that the company has only one register and merely a "transfer office" elsewhere:

> **M27125 - Inscribed and registered securities: duplicate or multiple registers of non-UK companies** [October 2007]
> Some overseas company laws allow a shareholder to use duplicate (or multiple) share registers to record the transfer of their securities.
> The South African Companies Act, for example, authorises South African companies to maintain branch registers in any foreign country. Shares can be transferred on any register, but no transfer of shares passing on death can be registered in the UK until any death duty claimed by South Africa on the shares has been paid.
> Remember that some registers merely record information about transfer of securities without providing the legal basis for the transfer. These registers do not affect the locality of the security (IHTM27071)
> Details of transfer arrangements given in the Stock Exchange Year-Book do not always make the position clear and, if necessary, you must ask the taxpayer to explain.

59.4.4 *Two effective registers*

If that fails one must look for another territorial connection:

> Where there are many registers the register upon which the shares would normally be dealt with in the ordinary course of business is the register that determines the locality of the security – see *Treasurer of Ontario v Aberdein* [1947] AC 24.

But which is the register which would normally be used? The Manual explains:

> If the share certificates are here, one of the alternative registers is here, and transfers can be effected here the shares will normally be regarded as legally situate here (*Re Clark, McKechnie v Clark* [1904] Ch 294).

R v Williams [1942] AC 541 is another example: the location of a (signed and endorsed) share certificate acting as a tie-breaker between two competing jurisdictions (each with a share register).[14] The Manual continues:

> This is only an assumption and as such can be rebutted by the particular circumstances of the case (see *Standard Chartered Bank Ltd v IRC* [1978] 1 WLR 1160). But if tax is offered on shares in a foreign company with transfer facilities in the UK, you can assume that the register here is the one on which the shares would normally be dealt with in the ordinary course of business.

59.4.5 *Company without "register" (in true sense)*

The IHT Manual provides:

> **27123 - Inscribed and registered securities: effectiveness of register**
> If shares are entered on a list, which could be called a register, but the register does not affect the legal holding of the security, the place where the list is situated does not affect the locality of the security.
> In *Erie Beach Co Ltd v Att Gen for Ontario* [1930] AC 161, certain shares (on the view that they could, under the Ontario Companies Act, be effectively dealt with only in Ontario) were held to be situated in that province for the purposes of Ontario Succession Duty, notwithstanding that they had in fact been entered on a "register" opened elsewhere.
> It was explained however, in *R v Williams*, that the *Erie Beach* decision

14 IHT Manual para 27150 [October 2007]:
"If the company has more than one register on which the holding could be effectively transferred, and the share certificates are found at the material time at a place where a register is located, the holding is for Inheritance Tax purposes situated at that place – see *R v Williams* [1942] AC 541. Cases where none of the effective registers is located where the certificates are found must be referred to TG or your Team Leader, in Scotland."

was based on the finding that the particular shares in question could be dealt with effectively in Ontario only. It is not an authority for holding that any company subject to the Ontario Companies Act is precluded from establishing registers outside Ontario on which effective transfers can be made, and Ontario companies like other Canadian companies may establish branch registers kept by "transfer agents" which are equivalent to duplicate or multiple registers (IHTM27125).

59.4.6 *Register of share transfers*

The IHT Manual provides:

27127 - Canadian companies: transfer agencies
Many companies incorporated under Canadian law keep a register, or branch register, of **transfers kept by one of the company's duly appointed "transfer agents", not a register of shareholders as with UK companies**.
When we ask ourselves "where could the shares be effectively dealt with" (*Brassard v Smith*), we must find out where the company has established transfer agents to operate a register, or branch register, of transfers. There usually is more than one such transfer agent with whom it is open to a shareholder to transfer his holding, regardless of where the relevant share certificate was issued; some (but relatively few) companies have such transfer agents in the UK. These equally available transfer arrangements in various places are said to be "interchangeable", and for the purposes of locality in relation to Inheritance Tax can be taken as equivalent to duplicate or multiple registers (IHTM27125).
This applies to shares registered in the name of the taxpayer or his nominee (including marking names), and applies whether or not the share certificates are endorsed in blank (*Treasurer of Ontario v Aberdein* [1947] AC 24). This will apply whether the company in question was incorporated under Canadian dominion or provincial law.

59.4.7 *Miscellaneous*

The IHT Manual provides:

27128 - Canadian companies: branch registers of British Colombian and Newfoundland companies

Branch registers can be kept outside the provinces so the location of the branch register will determine the locality of any shares registered thereon.

In certain circumstances shares registered on a branch register in the name of a **deceased member can be transferred only on a duplicate register kept at the registered office of the company. This restriction does not affect locality for Inheritance Tax purposes on the deceased's death**.

27129 - Canadian companies: Nova Scotia companies

Every company incorporated under the laws of Nova Scotia must keep a duplicate of any branch register kept outside the province at its registered office in the province. As regards transfers inter vivos, a distinction is understood to arise between:

1. Companies incorporated under the Nova Scotia Companies Acts, in which case a transfer inter vivos on a branch register appears to be valid and effectual in itself. Accordingly if the securities are registered on a branch register in the UK they must be treated as situated in the UK.
2. Companies incorporated under other Acts, in which case no transfer on a branch register is effectual until entered in the principal register. On that footing, registered securities may be regarded as situated in Nova Scotia, even though they may be registered on a branch register in the UK.

This restriction does not affect locality for Inheritance Tax purposes on the deceased's death.

59.5 Registered debt securities

The rules for debt securities[15] are, in general, the same as for registered shares; the passage from the IHT Manual set out above refers to securities, generally meaning both shares and debt securities.

59.5.1 *Place-of-register rule v specialty rule*

Shares are not "specialties" so the specialty rule cannot apply to them.[16] A debenture may be a specialty so the question arises as to the priority between the place-of-register rule and the specialty rule. The IHT Manual provides:

15 I use the term "debt securities" to mean securities which are not shares.

16 See 59.11 (Specialty obligation).

> **27079 Specialty rule: bonds and debentures under seal**
> Debentures if under seal, are specialty debts, locally situated where the document is found. So, also, are debts due from the Crown, or under a statute, whether under seal or under hand, and even when they are secured by registered bonds.

Thus for debentures the specialty rule overrides the place-of-register rule. For HMRC views as to which securities are in fact "specialties", see 59.11.3 (Situs of specialty).

59.6 Bearer documents

The place-of-register rule cannot apply to bearer shares as there is no register of shareholders.

59.6.1 *Bearer shares*

The general principle is that the shares are situate where they can be legally transferred: see 59.3 (Situs of shares general principle). Applying this rule it is clear that bearer shares are situate where the certificate is held.

59.6.2 *Bearer debt securities*

The leading case is *AG v Bouwens*.[17] This concerned foreign bearer bonds which were marketable in England and it was not necessary to do any act outside England in order to make a valid transfer of them. Lord Abinger said at p.192:

> No ordinary[18] in England could perform any act of administration within his diocese, with respect to debts due from persons resident abroad, or with respect to shares or interests in foreign funds payable abroad, and incapable of being transferred here; and therefore no duty would be payable on the probate or letters of administration in respect of such

17 (1838) 4 M & W 171 accessible *www.commonlii.org*. This was approved in *AG v Winans (No. 2)* [1910] AC 27.

18 Situs governed the jurisdiction of the Ordinary (an ecclesiastical office). The jurisdiction passed to the Court of Probate in 1857, and to the Chancery Division in 1875, but nothing turns on that.

> effects. But, on the other hand, it is clear that the ordinary could administer all chattels within his jurisdiction; and if an instrument is created of a chattel nature, capable of being transferred by acts done here, and sold for money here, there is no reason why the ordinary or his appointee should not administer that species of property. Such an instrument is in effect a saleable chattel, and follows the nature of other chattels as to the jurisdiction to grant probate.

This seems to state that the situs of bearer debt securities is where the document is to be found, and this is the view taken by Dicey,[19] HMRC agree. The IHT Manual provides:

> **27076 - Locality of assets (situs): bearer securities**[20]
> A security which is represented by a document of title, the property in which passes by delivery, is locally situated, for Inheritance Tax purposes, in the place where that document is found at the material time. *Att Gen v Bouwens*,[21] *Winans v Att Gen* [1910] AC 27.

59.7 Letter of allotment of shares

A letter of allotment confers the right to an issue of shares. The letter is normally transferable by delivery, just like a bearer security. One would have thought that the bearer security rule would apply. However, in *Young v Phillips* 58 TC 232 a letter of allotment in respect of a company with UK registered shares was held to be situate in the UK, not where the letter of allotment was held. This case concerned the common law rules before s.275A TCGA and is still relevant for situs for IHT, and for CGT in the case of foreign incorporated companies. Nicholls J cited the passage in *AG v Bouwens* set out above[22] and said:

> From this it is apparent that for an instrument to be treated as analogous to a chattel for situs purposes more is required of it than mere transferability of title by delivery. A simple contract debt owed by a foreign debtor to a person resident in England and evidenced by a promissory note might be, and normally would be, freely and effectively transferable in England, but

19 *The Conflict of Laws*, 14th ed, 2006, para 22-044. But for a dissenting view, see 59.7 (Letter of allotment of shares).

20 This passage applies to both shares and debt securities.

21 (1838) 4 M & W 171 accessible *www.kessler.co.uk*.

22 See 59.6 (Bearer documents).

> such a debt has as its situs the country where the debtor resides, not the place where the creditor lives or currently holds the promissory note. What is required is that in practice the value of the instrument can be realised by a sale of the instrument for money in the country where the instrument is found: the reason being that if an instrument in England could be so sold, the ordinary could properly and effectively administer that asset by selling it here, there being no need in such a case to have recourse to where the foreign debtor lived. When so saleable an instrument is in practice realisable in the same way as a saleable, valuable chattel, and hence, for situs purposes, it falls to be treated in the same way....

This approach requires an investigation into whether a market exists. The judge said:

> In the instant case there are no grounds for concluding that in practice the value of the letters of allotment, *which were issued with a life-span of a little over two months*, could have been realised by a sale of those documents for money wherever they were to be found. The Special Commissioners pointed out that no evidence had been led before them to prove that there existed a market in letters of allotment of shares in private companies. Having regard to the fact that shares in private companies may not be the subject of a public issue, they expressed themselves as being far from prepared to assume the existence of such a market. With that approach I agree. And it is to be noted that the "sales" of the letters of allotment which did take place in Sark were not arm's length transactions but were to purchasers wholly under the control of the vendors, and they had been prearranged even before the letters of allotment were issued. Accordingly, applying the principles I have mentioned to the facts of this case, the renounceable letters of allotment in the UK companies do not fall to be treated as saleable chattels, realisable where they might be found from time to time. They are documents evidencing rights against UK companies, which rights were enforceable in the UK.
>
> (Emphasis added)

The requirement for "marketability" is not well founded in the cases, nor does it make good sense. A buyer could be found for any valuable asset in any community where private property exists and one buyer makes a market.[23] Whether a market exists is a question of fact, so application of the marketability test will result in assets moving from one jurisdiction to another as markets come and go. It seems conceivable that there was no market in Sark (population 600). But with improved communications markets are no longer local to jurisdictions, as was assumed in *Young v Phillips*. An asset can be sold anywhere.

It seems that *Young v Phillips* stretched the law in order to defeat a tax avoidance scheme, and in doing so has left something of a mess.

The CG Manual provides:

> **12460. Letters of allotment** [March 2003]
> Letters of allotment should be treated as located in the country where the company issuing the letters is registered. In the case of *Young v Phillips* 58 TC 232 bonus shares were issued in respect of registered shares located in the UK. The issue was made in letter of allotment form. The letters were then taken to the Channel Islands and disposed of there. It was held that the letters of allotment were located in the UK because they evidenced rights which were properly enforceable only in the UK.

Thus in the HMRC view *Young v Phillips* is relevant to letters of allotment only, it has no relevance to the situs of bearer debt securities or shares which are governed by cases of much higher authority. It is suggested that the reasoning should be restricted to short life assets (such as the letters of allotment in that case which, it was stressed, had a life of only two months).

Even letters of allotment may be situate where the letter is situate, if there is a "market" there.

59.8 Securities held in clearing systems: depository receipts

There are no relevant statutory provisions, so the common law rules apply for IHT. But what is the rule? The IHT Manual deals with the matter briefly:

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23 This is self-evident, but for an illustration see *FGP v Union of India* 2004 (168) Excise Law Times 289 (Supreme Court of India) accessible on *www.kessler.co.uk*. Contrast the sophisticated definition of "asset for which there is a liquid market" in ICEAW Tech 7/03 para 19 (Guidance on the determination of realised profits in the context of distributions under the CA 1985).

27077 Locality of assets (situs): Eurobonds and American depository receipts
The situs of securities dealt with through computerised clearing systems (e.g. Euroclear; CEDEL) is regarded as determined by the terms of issue of the particular security. ...

A published statement is more helpful:

... where a financial institution or other intermediary has purchased Eurobonds or similar fungibles through Euroclear or Cedel on behalf of a client-investor, the Revenue will treat the financial institution or intermediary as the nominee or agent of the client-investor, unless the terms of the particular issue prescribed otherwise. So, save in the excepted circumstances, the Revenue will look through the intermediary and treat the beneficiary-investor as owning the underlying Eurobonds or similar fungibles.
We have also explained that, in the Revenue's view, the *situs* for IHT purposes of Eurobonds and similar fungibles in any issue depends on the terms of that issue and, in particular, where under those terms the bondholder's rights to or rights of action for property exist. Those rights will be determined by reference to general, not Revenue, law principles. So where title to the rights under an issue passes by delivery, the *situs* for IHT purposes of such rights is where the instrument of title is physically.
There is little we can add to the foregoing guidance. In particular we cannot offer any undertaking about the likely future IHT liability which may arise in respect of rights to particular Eurobond issues currently extant or which may be issued in future.
However, in order to be as helpful as possible, we can say that where a Eurobond issue satisfies the terms and conditions of section 124 ICTA 1988, the Revenue will treat for IHT purposes the rights and interests of the beneficiary-investors in such issues as rights to and interests in a bearer security.[24]

The CG Manual discusses depository receipts in more detail:

50240. Depository receipts: general
You may come across assets referred to as Depository Receipts (DRs). The commonest are American Depository Receipts (ADRs).
DRs are used as substitute instruments indicating ownership of securities such

24 [1994] PCB 139.

> as shares. Although DRs may be owned by anyone, they are designed primarily to enable investors to hold and deal in shares of companies located in countries other than their own. Such activities might otherwise be inhibited by difficulties in transferring original share certificates from one country to another. The investors hold or trade the DRs rather than the share certificates themselves.
>
> A person holding shares for which DRs are available can convert them into DR form by depositing the share certificates with a local branch of a depository (a financial institution such as a bank). The depository issues a DR. This document certifies that the depository, or an appointed custodian in the country of the underlying shares, holds the share certificates and that the owner of the DR is entitled to the share certificates on surrender of the DR. The precise detail of the arrangements may vary, but the holder of a DR will generally retain the rights attaching to ownership of shares, such as voting rights, and will receive via the depository any dividends on the shares, converted into the investors' local currency, or US Dollars for an ADR.
>
> The holder of shares in DR form may at any time cancel the arrangement by asking for delivery of the share certificates in respect of their underlying shares, and surrendering the DRs at a local branch of the depository.
>
> **50241. Tax analysis**
>
> For capital gains purposes the holder of the DR has two separate chargeable assets, namely
>
> - a beneficial interest in the underlying shares, and
> - the DR (being the document evidencing title, and comprising a number of rights as against the depository).

This is not correct. Firstly whether the holder of a DR has one or two assets is a question of general law; it is not possible to hold two assets "for CGT purposes" if one holds one asset as a matter of general law. Secondly, a DR is as a matter of general law one asset and not two. Admittedly the DR confers a bundle of different rights, but so does a share; so do most items of property which are nevertheless to be regarded as a single item of property and not as two or more distinct items. However, the Manual goes on to effectively ignore its two-asset analysis. In the view of the Manual the only asset which matters is the beneficial interest in the underlying share:

> A disposal of shares in DR form is therefore in strictness a disposal of two separate assets. In general, however, the value of a DR may be expected to track closely that of the underlying shares. So the consideration on any disposal may relate entirely, or almost entirely, to the shares themselves. In practice therefore you may not need to make any apportionment of base cost, or consideration received, on a disposal of shares in DR form.

CG Manual comments on the CGT consequences of conversion.

> **50242.**
> If a person 'converts' shares into DR form, there is no change in their ownership of the underlying shares, but they have acquired a second asset, the DR itself. If a person 'converts' their DR back into the underlying shares, there is again no change in their ownership of the shares, but there will have been a disposal of the separate DR asset. Normal TCGA principles would apply to this disposal. Normally there will be no chargeable gain on such an event.

The CG Manual then turns to consider situs:

> **50243. Tax analysis – situation of assets**
> Although the DR itself may be issued outside the UK, you should not accept any suggestion that a disposal of shares in a UK registered company held in DR form by a non-domiciled person should give rise to chargeable gains only on a remittance basis, see CG25300+. It is to be expected that the great majority, or all, of any consideration on such a disposal will be attributable to the disposal of the beneficial interest in the shares themselves. The shares are, under Section 275[1](e) TCGA, assets located in the UK, see CG12451, so the remittance basis will not apply.

As a statement of the common law situs rules, this is not correct. In general the rule is that a bare trust is transparent for situs; that is, the situs of the interest of the beneficial owner is that of the underlying asset.[25] But a DR is unlike an ordinary bare trust in that it is dealt with (i.e. transferred) in the jurisdiction of the depository. That is the jurisdiction where litigation over the transfer of a DR should take place. So that is the situs of the DR; the situs of the underlying security is irrelevant. Dicey agrees:

> ... the general principle is that the *situs* of a chose in action is where it is recoverable or may be enforced. ... Furthermore, there is an analogy between immobilised securities and registered securities (which are normally regarded as situated where the register is located). Accordingly, the *situs* of immobilised securities should be regarded as the place where the depository is established and where it keeps the database in which the entitlements of the depositors are recorded.[26]

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25 See 59.24 (Interest under bare trust or nomineeship).

26 14th ed para 22-043. This view is enthusiastically supported by Joanne Benjamin's *Interests in Securities*, OUP, 2000, Chap 7. See too an interesting posting to the Trusts Discussion Forum V2 # 74 (Peter Cushen).

This is also supported by Canadian authority:

> The place where the central securities depository control account is located could [and should] be considered the situs of "dematerialized" securities. In a multi-tiered holding system, the account would be situated at the financial investment intermediary on whose books the interest of the debtor appears. This is the place where the record that determines title is to be found.[27]

It must be frustrating for HMRC to see a significant part of the economy taken out of the scope of IHT by means of depository receipts. Though in practice IHT on such assets would be largely uncollectable. It is likely that HMRC will back down on this point if pressed.

59.9 Share certificate endorsed in blank

The IHT Manual explains the background law as follows:

> **27150 - Locality of assets (situs): share certificates endorsed in blank** [October 2007]
> Certificates of many American and Canadian railroads and of certain other companies have a printed form of transfer and/or power of attorney endorsed, which enables the certificates, when the form is signed by the registered holder of the shares, to be transferred by delivery.
> It is common practice for such certificates to be "endorsed in blank", i.e. for the endorsement to be signed by the registered owner as transferor, the name of the transferee being left blank.
> Dividends are paid by the company to the registered owner, and if these shares have in fact changed hands by delivery, the beneficial owner for the time being recovers his dividends from the registered owner.
> Usually the shares are registered in the name of a recognised broker, bank, discount house, etc, known in England as a "good Marking Name" or, in America, as a "Street Name". This helps to make sure that the purchaser receives their dividends with minimum of trouble and risk.
> A list of good Marking Names recognised by the London Stock Exchange is printed in the Stock Exchange Official Year Book.
> However the beneficial owner can have them registered in their own

27 *Re Bloom* [2004] BCSC 70, 27 BCLR (4th) 176, accessible *www.canlii.org*.

name, or in the name of some nominee other than a good Marking Name.

The local situation of shares for Inheritance Tax purposes is determined as followings:

[a] If the registered owner is a good Marking Name, the shares are situated where the register is kept, not where the certificates are found....[28]

[b] If the registered owner is the beneficial owner himself, or a nominee of the beneficial owner, or, in the case of settled property, the trustees of the settlement or their nominees, the rules are as at (a) above.[29]

The HMRC view is that one ignores the fact a share transfer form has been endorsed in blank. This is right, because the endorsed certificate does not alter the place where registered shares are dealt with as between shareholder and company: see 59.3 (Situs of shares: general principle). At this point the Manual becomes confused:

[d] If the registered owner is neither a good Marking Name, the beneficial owner, nor any other of the persons named at (b) above, and the certificates are physically present in the UK at the material time, the shares are locally situated in the UK for Inheritance Tax purposes, (*Stern v The Queen* [1896] 1 QB 211).

I find it hard to see how [d] can apply: the registered owner will always be one of the persons named at [b] (beneficial owner or a nominee).

Certificates of this kind, not containing any express obligation or promise, are not specialty debts – see the *Williams* case at [1942] AC 556.

That is correct.

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28 Omitted text set out at 59.4.2 (Overseas branch registers).

29 The Manual continues:

"[c] In such cases it is considered that the legal and only title of the holder consists in his registration as owner. By bringing the certificates to the UK he is in a position to create, in a purchaser, an equitable interest in the shares which would be situated here, but until he does so the beneficial interest has not been severed from the legal interest so as to have a different locality."

This is garbled, or muddled and wrong.

59.10 Simple contract debt

The IHT Manual provides:

> **27091 - Debts: contractual**
> In English law, a **simple**[30] **contract** debt is situated where the debtor resides: *Att Gen v Bouwens*;[31] *English, Scottish and Australian Bank Ltd v IRC* [1932] AC 238.

I refer to this as the place-of-debtor rule. It can be traced back to Elizabethan times.[32]

A winding-up order against the debtor does not affect the situs of the debt,[33] but judgment against the debtor (turning the debt into a judgment debt) does do so.[34]

59.10.1 *Reason for place-of-debtor rule*

Many cases simply state the place-of-debtor rule without giving any reason for it. There is no reason why the rule should have a reason, as any rule is bound to be arbitrary and any clear rule is better than none.

Some cases offer the reason that (1) the debt is situate where it can be enforced, and (2) it is enforced where the debtor resides.[35] This raises a difficulty where the debtor resides in one jurisdiction but the debt is enforceable in another. *Raiffeisen Zentralbank v Five Star Trading* [2001] QB 825 at [36], [37] supports the rule that one should look to residence, regardless of where the debt would be enforced:

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30 [Author's note] A "simple" contract is one which is not a specialty. Different rules apply to judgment debts and bank accounts: see below.

31 (1838) 4 M & W 171 accessible on *www.kessler.co.uk*.

32 *English Scottish & Australian Bank v IRC* [1932] AC 238 at p.248.

33 *Wight v Eckhardt* [2004] 1 AC 147. In practice this issue will not usually arise.

34 See 59.14 (Judgment debt).

35 *New York Life Insurance v Public Trustee* [1924] 2 Ch 101. It has also been suggested that the reason for the rule is that the debtor's place of residence is where the assets used to satisfy the debt will most probably be found: *New York Life Insurance* at p.114 following *Commissioner of Stamp v Hope*. But it would be better to say the rule has (and needs) no reason than to give such a slender reason as this, for where a debtor is resident in country A, but his assets are in country B, no-one suggests his debt is situate in country B.

> [36] In the case of intangible property, English law has, for various purposes (e.g. inheritance), traditionally allocated to it a situs at the place of the debtor's residence. This is on the basis that the debtor is there directly subject to the coercive power of the courts to enforce the obligation. The location of a right of action in this or any way is, however, evidently artificial. Parenthetically, I add that "coercive power" would itself appear to be an unstable international concept, capable of widely differing interpretation ...
> [37] Modern conditions underline the artificiality of selecting supposed control at the debtor's residence as an appropriate basis for characterisation or choice of the relevant law to determine questions regarding the validity or effect as against the debtor of an assignment. Jurisdiction may be grounded on consent and various other bases apart from residence. Obligations are commonly enforced today not against the person, but against assets. Debtors often trade or hold some or even all of their assets overseas. Proceedings are as a result often begun and enforced against debtors in countries other than that of their residence, as in this case. The move towards single legal markets, like those involving countries party to the Brussels and Lugano Conventions, makes judgments readily exportable between countries.

Although the historic reason for the place-of-debtor rule no longer holds, the rule still survives and is as good as any other. Well-established precedents are not overturned merely because their historic reason has become unsound. So it is submitted that the law is settled.

59.10.2 *Dual resident debtor*

Where the debtor is dual resident, the place-of-debtor rule does not provide a solution. A tie-breaker is need, and the solution adopted in *New York Life Insurance Co v Public Trustee* [1924] 2 Ch 101 was where the debt was payable. For this purpose the test of residence for a company is not the usual tax test (management and control) but where the company carries on business: *Kwok Chi Leung Karl v CED* [1988] STC 728 at 733.

59.11 Specialty obligation

59.11.1 *Meaning of "specialty"*

"Specialty" is an opaque technical term whose meaning can only be ascertained from the case law. Four categories of asset are "specialties":

(1) The paradigm example of a specialty is a debt due under a deed.
(2) The term also applies to deeds which create or record obligations which are not debts.[36] A life policy, contract for deferred annuity, capital redemption policy and the like are specialties if made by deed. Shares are not specialties.[37]
(3) The term also includes a debt incurred under a statute, whether or not it is a debt under a deed.[38]
(4) Certain debts are by statute given the nature of a specialty debt.[39]

For a document to be a "deed" in English law it was formerly a requirement that the document must be sealed. The requirements under the Law of Property (Miscellaneous Provisions) Act 1989 are now that the deed must be signed, witnessed, delivered, and must "make it clear on its face that it is intended to be a deed". These rules govern the meaning of "specialty". So a seal is not now required for an English law document to be a "specialty".[40] No particular form is necessary to be a "specialty" beyond the formalities of a deed.

As a shorthand, a deed was often referred to as a document "under seal" and a non-deed as a document "under hand". This usage is now out of date but it is still found in HMRC Manuals.

59.11.2 *Documents governed by foreign law*

Authority is scant, but it is suggested that the position depends on whether the foreign law has a concept of a "deed" (and a "specialty").

A document governed by foreign law which recognises "deeds" is a specialty if it is executed in accordance with the local law requirements of a deed. In the Isle of Man, for instance, a seal was never required except

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36 In *Aiken v Steward Wrightson Agency* [1995] 1 WLR 1281 the term was applied to a contract by deed to provide services (and an action for breach of that contract was held to be an action "upon a specialty" so as to qualify for a 12-year limitation period).

37 *R v Williams* [1942] AC 541.

38 *Royal Trust Co v AG for Alberta* [1930] AC 144.

39 e.g. s.14(2) CA 1985: "Money payable by a member to the company under the memorandum or articles is a debt due from him to the company, and in England and Wales is of the nature of a specialty debt."

40 The Law Commission took this view in Working Paper No. 85 (1985) and Report No. 253, para 2.12ff.

for corporations, though for a document to be a deed the parties must intend it to be a deed.[41]

A document governed by a foreign law which does not recognise deeds will be a specialty if it is executed in accordance with the English law requirements of a deed, even though the local jurisdiction does not recognise deeds.[42]

59.11.3 *Situs of specialty*

The IHT Manual provides at para 27091:

> A specialty debt is situated where the instrument happens to be.

I refer to this as "**the specialty rule**".[43] This rule (like the place-of-debtor rule) can be traced back to Elizabethan times.[44] So a debt due from a UK resident can be made non-UK situate for IHT by drafting the debt as a specialty and keeping the document offshore. Conversely a debt, policies, and other specialities can be made UK situate for IHT by bringing the deed here.

The specialty rule requires one to ascertain whether a debt is a specialty, and the IHT Manual offers a little guidance:

> **27079. Bonds and debentures under seal**
> Debentures if under seal, are specialty debts, locally situated where the document is found. So, also, are debts due from the Crown, or under a statute, whether under seal or under hand, and even when they are secured by registered bonds.
> Most UK government securities (e.g. Treasury Loan, Exchequer Stock, War Loan) are registered, so that their locality is determined by the place of registration. However, some bonds issued by the UK government (containing an express obligation to pay) are governed by the general rule that a debt due from the Crown is a specialty debt, situated where the document evidencing the obligation is physically

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41 *Aall Trust & Banking Corporation v Samuel McCormick* 2 OFLR 85, Butterworths Offshore Service Cases, Vol 2, p.479.

42 *Alliance Bank of Simla v Carey* (1880) 5 CPD 429.

43 *Att Gen v Bouwens* (1838) 4 M & W 171 accessible on *www.kessler.co.uk*. This was approved in *AG v Winans (No. 2)* [1910] AC 27; *Comr of Stamps (New South Wales) v Hope* [1891] AC 476.

44 *English Scottish & Australian Bank v IRC* [1932] AC 238 at 248.

found.

In *Royal Trust Co v Att Gen for Alberta* [1930] AC 144, the decision related to registered bonds of the Dominion of Canada and their situation for the purpose of Alberta death duties.

27080. Treasury Bills, British Savings Bonds, National Savings Income Bonds [June 2005]

Securities falling within the specialty rule includes [sic] Treasury Bills and British Savings Bonds. (IHTM27078)

Although no actual bonds are in existence holders receive a bond book or, in some cases, a certificate. When the person beneficially entitled to these bonds is domiciled outside the UK, the bonds are regarded for Inheritance Tax purposes as situated outside the UK at any time that the bond book or certificate is situated outside the UK.

National Savings Income Bonds, however, are securities registered on the National Savings Stock Register and as such are situate in the UK.

(This text has been withheld because of exemptions in the Freedom of Information Act 2000)

Perhaps the withheld text states how HMRC check that bonds are not omitted from IHT account. The Manual continues:

27091 ... Corporation mortgages, issued by local authorities under seal, and Northern Irish Land Bonds, are examples of specialties, situated where the instrument is located. (Corporation mortgages should not be confused with Corporation stock, which is far more common and which is a registered security situated where the register is kept.)

This rule overrides the place-of-register rule: see 59.4 (Situs of registered shares).

59.11.4 *Scottish specialties*

The IHT Manual continues:

27092 - Debts: debts in Scotland

In Scotland, the rule that a debt is situated where the debtor resides applies alike to specialty (IHTM27078) debts and to those due on simple contract. For Inheritance Tax purposes debts due from persons resident in Scotland are regarded as locally situated there. If any difficulty arises in applying this rule, refer the case to TG (IHTM01081).

Any case where a Scottish instrument under seal is outside the UK and

> the locality of the asset determines whether or not an allowance under s.159 IHTA is admissible must also be referred to TG for consideration. This direction relates to specialty debts generally. It covers, for example,
> [1] mortgages under seal,
> [2] policies under seal, and
> [3] covenant debts, and
> [4] also applies to debts due from the Crown, or due under a statute.

I find the comments relating to Scotland somewhat surprising and would be grateful to any reader who could direct me to relevant Scots authority.

59.11.5 *Reason for the specialty rule and future developments*

What is the reason for this rule? In *R v Williams* [1942] AC at 555 the Privy Council offer this explanation:

> Such an obligation [a specialty debt] was for centuries treated as very different from an ordinary debt. Indeed, the act of creating a specialty by deed was at one time possible only to men of the highest rank. Unlike debt, it was enforced by an action of covenant[45]: Holdsworth, *A History of English Law*, 3rd ed., vol. iii., p. 417. The deed itself was the foundation of the action, the original debt, if any, being merged. The terms of the deed were conclusive. Specialty debts till recent [?] times conferred special rights. They used to rank in the administration of the estate of a deceased person in priority to simple contract debts[46]; and, unlike such debts, were enforceable against the real estate.[47] They were said to be "of a higher nature" than debts by contract. It is, therefore, not surprising that specialty debts by deed were treated from an early date as bona notabilia [i.e. assets situate] where the deeds were found at the time of the death, unlike ordinary debts which were said "to follow the person of debtor".

In this reasoning the conclusion does not follow from the premises, and in any case the premises have long ceased to be valid in English law. The rhetorical language (not for the first time) conceals a weakness in the reasoning. One might conclude that the specialty rule has no good reason but *Commissioner of Stamps v Hope* [1891] AC 476 offers a better

45 This rule was abolished by the Civil Procedure Act 1833.
46 This rule was abolished by the Administration of Estates Act 1869.
47 This rule was abolished by the Administration of Estates Act 1833.

explanation:

> ... the distinction drawn and well settled has been and is whether it is a debt by contract or a debt by specialty. In the former case, the debt being merely a chose in action – money to be recovered from the debtor and nothing more – could have no other local existence than the personal residence of the debtor, where the assets to satisfy it would presumably be, and it was held therefore to be bona notabilia [i.e. assets situate] within the area of the local jurisdiction within which he resided; but this residence is of course of a changeable and fleeting nature, and depending upon the movements of the debtor, and inasmuch as a debt under seal or specialty had a species of corporeal existence by which its locality might be reduced to a certainty ... it was settled in very early days that such a debt was bona notabilia where it was "conspicuous," i.e. within the jurisdiction within which the specialty was found at the time of death: see *Wentworth on the Office of Executors*, ed. 1763, pp. 45, 47, 60(1).

The reason for the rule is not that the specialty has a "species of corporeal existence".[48] The reason is that the specialty rule is certain and easier to apply than a place-of-debtor rule. There is a little sense in that.

A bold House of Lords might one day sweep these dusty cobwebs away. But the issue of situs rarely arises nowadays outside tax cases. HMRC are not likely to argue the point against their own Manuals. It will not normally be in the interest of a taxpayer to argue against the specialty rule, as a well-advised taxpayer will keep his specialties outside the UK. So the courts are not likely to have that opportunity to examine the issue (except perhaps in litigation relating to Scotland or in the Privy Council). The House of Lords has shown itself prepared to amend long established common law rules, such as the rule that there is no recovery for payments made under a mistake of law. But it has generally done so when the old law not only lacks a logical basis but is also conducive to injustice. That is not the case here. Well-established rules are not overturned merely because the underlying principle is logically unsound. So it is submitted that the rule will remain even if challenged in the Lords. It should be

48 That is either tautologous (if "having a species of corporeal existence" means "situate where the deed itself is situate") or metaphysical (if "having a species of corporeal existence" means anything more than "situate where the deed is situate"). It is not, after all, the case that transfer of the deed brings about a transfer of the debt or right to which the deed relates.

abolished (if at all) by Parliament.[49]

59.12 Debt secured on land

59.12.1 *Specialty debt charged on land*

In the case of a specialty debt charged on land, the choice lies between the location of the land and the specialty rule (location of deed).

Let us look at the matter as one of principle. Is the rule that situs depends on location of the land a sensible or workable rule? It is not, for the following reasons:

(1) One debt may be charged on land in two different countries. A secured debt confers a bundle of different rights, including:
(a) right to sue on the covenant;
(b) right to sell if the debt is unpaid;
(c) right to foreclose if the debt is unpaid.
However, this bundle is a single asset. It cannot be situate in both countries.

(2) The rule becomes absurd if a large debt happens to be secured on an asset of small value. Would one say a £100m debt is situate in Jersey if it is secured on a property there worth £100,000? But obviously one cannot have a rule where the situs depends on relative values of the debt and the security which may fluctuate enormously from time to time.

(3) It has never been suggested that a debt charged on (say) shares is situate where the shares are situate but there is no good reason to distinguish between shares and land.

The only sensible rule therefore is to apply the specialty rule and ignore the fact that the debt is secured.

The case law is complicated. The law got off on the right footing with *Commissioner of Stamps v Hope* [1891] AC 476. Here the debt was a specialty secured on land in New South Wales. The deed was held in Victoria. The question was situs for the purpose of probate duty and the Privy Council held that the debt was situate in Victoria.

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49 It is interesting to note that the specialty rule was disapplied for probate duty: s.39 Revenue Act 1862 and it does not usually apply for CGT.

Only three years later the Privy Council muddied the waters in *Walsh v The Queen* [1894] AC 144. Here there were a variety of debts, some secured on property in and out of Queensland. It was held that the debt should be regarded as being in Queensland up to the value of the property there. The best explanation of this case is that it did not concern the common law situs rule. The case turned on the specific statute (the Queensland Dividend Duty Act 1890) which (by implication) operated an entirely different situs rule. This explains why the earlier case of *Commissioner of Stamps v Hope* was not referred to in the judgment of the Privy Council.

Payne v R [1902] AC 552 concerned a specialty debt charged on land in Victoria. The deed was in New South Wales. The Privy Council held at p.560 (without citing authority or any discussion) that a mortgage debt was a specialty debt in New South Wales and a simple contract debt in Victoria. That is obviously wrong. They also held the asset was situate in Victoria *and* New South Wales, which (although followed in *Henty v The Queen* [1896] AC 567) is not now the law.[50] The comments must be dismissed as now overruled or *per incuriam*.

Toronto General Trust Corporation v The King [1919] AC 679 is an exceptional case that proves the existence of the general rule. Here a mortgage debt was represented by two duplicate deeds, one in Ottawa and one in Alberta. In such a case one cannot apply the rule that the debt is situate where the deed is situate, so it is sensible to fall back on the simple contract rule. But had there been only one deed, it is plain that the debt would have been situate where the deed was.

Dicey notes that a mortgage debt is normally a specialty and continues:

> [1] A mortgage of land confers an interest in land and will be held situate where the land is situate,[51]
>
> [2] but where it is necessary (e.g. for taxation purposes) to distinguish between the situs of the mortgagee's interest in land and that of the mortgagor's personal obligation to repay, then the latter (if in the form of a specialty) will be held situate where the deed is situate from time to time.[52] …
>
> [3] In the conflict of laws the distinction between the interest in land

50 See 59.2 (Every asset has one situs).

51 [Dicey's footnote] *Re Hoyles* [1911] 1 Ch 179.

52 [Dicey's footnote] See *Walsh v The Queen* [1894] AC 144; *Payne v R* [1902] AC 552. Also *Henty v The Queen* [1896] AC 567.

> and the personal obligation is not normally made for the purposes of situs, and the asset is regarded as a unity which is situate in the country where the land lies.[53]

Dicey's view at [1] and [3] is that the location of the land prevails. With respect, this overlooks the authorities cited above. The case cited, *Re Hoyles*, does not support Dicey. It shows that for the purposes of succession law a mortgage debt is dealt with according to the law of the land. However, it does not follow from this that the debt should be regarded as situate in that country for the purpose of the situs rules and situs as such is nowhere discussed in *Re Hoyles*. The suggestion at [2] is that tax law may distinguish between the mortgagee's interest in land and the mortgagees's right to payment. But the distinction is an almost impossible one, and nowhere drawn in tax law (apart from *Walsh*, not a situs case).

The IHT Manual passage cited above[54] suggests that the HMRC view is (like mine) that the specialty prevails, not the location of the land.

59.12.2 *Simple debt charged on land*

In the case of a simple debt charged on land (not made by deed) the choice lies between:

(1) The location of the land.
(2) The simple debt rule (situs is residence of debtor).

The arguments of principle suggest that the simple debt rule prevails. This conclusion is also supported by the passage from *Raiffeisen* cited in 59.10 (Simple debt situs for IHT). This conclusion is consistent with the position for specialty debts secured on land.

59.13 Debt under letter of credit

The IHT Manual para 27091 provides:

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53 [Dicey's footnote] *Re Hoyles* [1911] 1 Ch 179; *Dicey* para 22–012; c.f. Falconbridge, *Selected Essays on the Conflict of Laws*, 2nd ed. 1954 pp.573–580 for an acute discussion of this problem.

54 59.11.3 (Situs of specialty); note the references to mortgages in the quotation from the IHT Manual.

A debt under a letter of credit has been held to be situated in the place where it is in fact payable against documents (*Power Curber International v National Bank of Kuwait* [1981] 3 All ER 607).

59.14 Judgment debt

A judgment debt is situate where the judgment is recorded.[55] Obtaining judgment may therefore have the effect of changing situs, for better or worse.

59.15 Bank account

The IHT Manual provides:

> **27093 - Debts: Bank accounts** [October 2007]
> A bank account is a debt, and under general law is situated at the branch of the bank where the account is kept: *R v Lovitt* [1912] AC 212.[56]
> This general law rule may be modified for IHT purposes by a Double Taxation Convention ...

UK bank accounts may, however, qualify for an IHT relief.[57] Guidance on what constitutes a branch of a bank can be found in the discussion of branch and PE.[58]

59.16 Building society account

A standard form building society account is not a debt, it is an interest in the society, so corporation situs rules rater than debt rules should be applied.

The IHT Manual provides:

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55 *AG v Bouwens* (1838) 4 M & W 171 accessible on *www.commonlii.org*.

56 In the Law Reports the name of this case is: *The King v Lovitt.*

57 See 44.19 (Non-residents foreign currency bank accounts).

58 See 64.2 (Meaning of permanent establishment); 64.11 (Meaning of "branch or agency").

27151 - Locality of assets (situs): [bank or][59] building society accounts in Channel Islands and Isle of Man
Any case in which it is claimed that an account with a UK Building Society must be treated as situated in the Channel Islands or the Isle of Man, and therefore as exempt from IHT, must be referred to TG (IHTM01081), your Team Leader must be consulted in Scotland.

59.17 Insurance policy

For the purpose of situs rules a policy is regarded as a debt, so the place-of-debtor and specialty rules apply.[60] The IHT Manual correctly provides:

27101 - Policy monies: general rule
When the policy is under hand the policy monies are situated where the debtor (company) is resident (generally the head office of the company)
...
27102 Payment made at place other than Head Office
Where under the terms of the policy, payment is to be made at some place other than the residence of the head office the monies are deemed to be situated at the place of payment (*New York Life Insurance Co v Public Trustee* [1924] 2 Ch 101).

27103 Policy issued at branch office
If[61] a policy is issued by, or through, a branch office of a UK company, outside the UK, and no reference is made in the terms of the policy as to the place where the policy monies are to be paid.
Policy monies are to be treated as situated in the country of the branch office provided that the whole course of business in relation to the policy had been transacted in that country.
The "whole course of business" connotes the happening of all the following events in the country of the branch office:
- that the policy is issued to a resident in that country from the branch in that country
- that the holder of the policy remains resident and retains the policy there, pays the premiums to the branch there, and dies there

59 The reference to a "bank" in the heading seems to be erroneous since the text only relates to building societies.
60 *New York Life Assurance Co v Public Trustee* [1924] 2 Ch 101.
61 The text has gone wrong here: The previous Manual read: "A further type of case is one in which the policy *etc*"; and that is clearly the meaning. Probably the first two paragraphs are intended to form one sentence.

- that representation to his estate is taken there and the money collected there.

With regard to condition (b) if at the date of the life assured's death, the policy is in the UK at the Assurance Company's head office and the life assured has assigned the policy to the assurance company as security for a loan, do not assume that the policy was situated in the UK without considering the other circumstances surrounding the policy.

Divergence in detail (for example, discontinuous residence) would not necessarily lead to a different conclusion. However if any of the conditions is not fulfilled, or where the locality of the policy has to be determined before the policy holder's death, each case must be considered on its own facts. Any such case must be referred to TG (IHTM01081).

Where a policy under hand in terms provides for payment **either at its head office or** at a branch office, and the "whole course of business", in the sense indicated above, takes place in the country of the branch office, the monies are also treated as locally situated in that country.

Some of para 27103 is doubtful but the practice will normally favour the taxpayer so the issues will not often arise.

59.17.1 *Policy made by deed*

The IHT Manual correctly provides:

> **27104 - Policy monies: policies under seal**
> Policies under seal are specialty debts (IHTM27078).

This is correct. It requires one to investigate whether policies are specialties. The IHT Manual gives a little guidance at 27104:

> Most Lloyds policies are embossed with a seal but they are not specialties unless additionally they bear the witnessed personal signature of the General Manager of Lloyds Policy Signing Office.

On IHT treatment of UK situate policies see 22.12 (IHT on UK situate policies).

59.18 Land

The IHT Manual provides:

27074 - Locality of assets (situs): land/interest in land [October 2007]
Immovable property is situated where it is actually located, but you must note that in the case of some types of interest either in land or relating to land, different legal systems may take opposing views as to whether they constitute movable or immovable property.
These differences are resolved (under Private International Law, and also by specific provision in Double Taxation Conventions where these apply) by the adoption of the view taken by the law of the country in which the land itself is situated: *Johnstone v Baker* (1817) 4 Madd 474; *Macdonald v Macdonald* [1932] SLT (HL) 381.
Land is usually classed as immovable property, and so is generally governed by the law of the country in which the immovables are situated. This issue of devolution may be especially significant here when ascertaining the exemption of foreign property that may or may not pass to a surviving spouse or civil partner (IHTM11032).

59.19 Securities of international organisations

The IHT Manual provides:

27141 - Securities issued by international organisations: list of non-UK situs organisations [October 2007]
Unless in bearer form and situated physically in the UK securities issued by the following organisations are effectively outside the charge to IHT where:
1. they form part of the estate of a person domiciled outside the UK
   or
2. they are comprised in a settlement and the settlor was not domiciled in the UK at the time the settlement was made, namely:
   - the International Monetary Fund:
     The Bretton Woods Agreement Order in Council, 1946 ((SR & O) 1946 No 36)
   - the International Bank for Reconstruction and Development:
     The Bretton Woods Agreement, as above
   - the International Finance Corporation:
     The International Finance Corporation Order, 1955 (SI 1955 No 1954)
   - the International Development Association:
     The International Development Association Order, 1960 (SI 1960 No 1383)

This list of organisations may not be exhaustive if you receive a claim for exemption in respect of a security issued by any other international body refer the papers to TG (IHTM01081) or your Team Leader (Scotland).

27142 - Securities issued by international organisations: designated as non-UK by Treasury
By Statutory Instrument the Treasury can designate securities issued by certain international organisations as situated outside the UK for the purposes of s.126 FA 1984 extended by s.96 FA 1985(now s.324 ICTA).
The following organisations have been so designated.
1. The Asian Development Bank: The International Organisations (Tax Exempt Securities) Order 1984 (SI1984/1215) made on 2 August 1984
2. The African Development Bank: The International Organisations (Tax Exempt Securities) (No 2) Order 1984 (SI1984/1634) made on 22 October 1984
3. The European Community; The European Coal and Steel Community; The European Atomic Energy Community; The European Investment Bank: The European Communities (Tax Exempt Securities) Order 1985 (SI 1985 No 1172) made on 25 July 1985 in respect of a. and d.
4. The European Bank for Reconstruction and Development: The International Organisations (Tax Exempt Securities) Order 1991 (SI1991/1202) made on 16 May 1991.
Accordingly any security issued by the above mentioned organisations automatically has a foreign situs for IHT where the event occurred on or after the date of the order.
27143 - Securities issued by international organisations: OECD & Inter-American Development Bank
Any security issued by the OECD support fund or the Inter-American Development Bank is treated as situated outside the UK for IHT purposes: s.4(1) OECD Support Fund Act 1975 and s.131(2) FA 1976 respectively.

59.20 Chattels

The rule is what one would expect. The IHT Manual provides:

> Chattels are situated where they happen to be at the relevant time.[62]

It is suggested that this applies even where:

(1) a chattel is moved out of the UK;
(2) the chattel is transferred to another person or trust;
(3) the chattel is returned to the UK.

The temporary removal of the asset at the time of the disposal cannot be ignored, for tax purposes, even if the time spent out of the UK is short.

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62 The text is found twice: IHT Manual paras 21047 and 27075. For a concession on works of art see 44.20 (Works of art).

59.21 Ships and aircraft

The IHT Manual provides:

> **27073 - Locality of assets (situs): ships**
> A ship on the high seas is deemed to be situated at its port of registry but when it comes within territorial waters this artificial situs is displaced by the actual situs: *Trustees Executors & Agency Co Ltd v IRC* [1973] Ch 254.

The situs of aircraft for IHT is, surprisingly, undecided. The choice lies between the chattel rule, the ship rule and the place of registration. In *Kuwait Airways v Iraqi Airways (Nos 4 & 5)* [!] [2002] 2 AC 833 no attempt was made even to argue for place of registration. It is suggested that the ship rule is the most sensible solution.

59.22 Goodwill

Goodwill is situate where the trade or profession is carried on (see *IRC v Muller* [1901] AC 217) but because of IHT business property relief, the issue will not often arise.

59.23 Property subject to contract of sale

An interest in English land subject to a contract of sale is still situated in the UK: *Re Clore, IRC v Stype Investments* [1982] STC 625. It is suggested that a contract of sale does not affect situs.

59.24 Interest under bare trust or nomineeship[63]

The interest of a beneficial owner in property held by a nominee or bare trustee is situate where the underlying asset is situate: a nomineeship or bare trust is transparent for situs. See *Re Clore, IRC v Stype Investments*

63 For present purposes the terms "bare trust" and "nomineeship" are identical.

[1982] STC 625 at 633/4 (where land in England was held by a Jersey nominee). The practice of HMRC is to look through nomineeship of all kinds.[64] Thus it is quite safe for a foreign domiciled individual (or trust with a foreign domiciled settlor) to hold foreign securities through a UK stockbroker's nominee.

What happens in practice if an individual with no connection to the UK dies holding a portfolio of securities including UK situate securities held by a nominee? I suspect that it is not the practice of the nominee to require a grant of probate in every jurisdiction in which the securities are situate, though it has been suggested that this would be desirable.[65] Otherwise it may be necessary to seek grants in many jurisdictions and the administration of estates would be made considerably more difficult. If it is correct that a nominee for an individual unconnected with the UK, holding UK situate assets, does not require probate then the IHT strictly payable on the death of the individual in respect of the UK situate securities held by the nominee is uncollectable. This brings into question the proposition that securities situate in country A held by nominees in country B should be regarded as situate in country A and not in country B. The rule that one looks through nominees holding securities (as opposed to land) makes little sense in current market conditions. But the opposite rule would have disastrous consequences for situs as no foreign domiciled individual (or trust with a foreign domiciled settlor) could use UK stockbroker nominee services. Tax planning would be made very easy by use of foreign nominees. So the status quo is better than the alternative. Moreover it is possible for securities situate in country A to be held by a nominee in country B who holds for a nominee in country C who holds for an individual. In such a case one cannot say that the situs of the individual's asset is that of the nominee. So the only workable rule is to look through nominees. Underlying the problem is the fundamental unsuitability of the common law situs rules to determine territorial limitations for tax purposes, at least in relation to intangible assets such as securities.

For unit trusts see 27.4 (Situs of unit).

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64 See 59.8 (Securities held in clearing system: depository receipts).

65 See the thread in the Trusts Discussion Forum, September 2002, under the heading "Onshore/Offshore" accessible on *www.trustsdiscussionforum.co.uk*.

59.25 Equitable interest under a substantive[66] trust

The situs of an equitable interest under a substantive trust is not often relevant for IHT, but it may matter, e.g. where a reversionary interest is not excluded property for IHT.

There are many connecting factors which might be used to attribute a situs to an equitable interest, and the courts have not had to consider all possible permutations. *Favorke v Steinkopff* 1922] 1 Ch 174 concerned an English law will trust, with English trustees, but German situate property; the equitable interests of an annuitant, life tenant and remaindermen were held to be situate in England. It is suggested that an equitable interest is normally situate where the trustees are resident. If the trustees are resident in different jurisdictions, situs would be determined by an exclusive jurisdiction clause if there is one, or failing that, by the proper law.[67]

There is a sound basis to say that situs of the assets of the trust fund is not relevant to the situs of the equitable interest. If the trust assets are situate in different jurisdictions it would be impossible to ascertain the situs of the equitable interest (if the equitable interest is regarded as a single asset). An equitable interest such as a life or reversionary interest should not be regarded as several separate interests in as many assets as are held by the trustees. Such an equitable interest is generally regarded as one asset and not as many assets as there are items of trust property.

Where the equitable interest is a power of revocation the position is even clearer. Where the equitable interest is an annuity, it would often be impossible to locate the annuity by reference to the situs of the trust assets, because one cannot identify any particular trust asset and say that asset is (to any fixed extent) the source of the annuity.

59.26 Unadministered estate of deceased person

The IHT Manual provides:

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66 By "substantive" I mean a trust other than a bare trust (nomineeship) or unit trust.

67 For a contrary view see Jonathan Harris, *The Hague Trusts Convention*, 1st ed., 2002, Chapter 9 (Situs of equitable interests).

> **27072 - Locality of assets (situs): unadminstered estates or shares therein**
> In general a person who takes an absolute interest as a residuary legatee, under English law and many other legal systems,[68] is entitled, not to the assets **in specie of the testator, but to a chose in action**, enforceable against the executors.
> This means the executors must administer the estate and transfer the clear residue, or a share thereof, as the case may be to the beneficiary.
> The same rule applies in the case of intestacy.
> This is a similar rule to the **ius crediti to which a Scots beneficiary is entitled**.

The "chose in action" is situate where it is enforced, i.e. where the executors are. The situs of the assets of the estate is not relevant. See *CSD v Livingston* [1965] AC 694. The IHT Manual continues:

> For IHT however, the deceased is treated as having a direct interest (in the whole or a share, as the case may be) in the net assets of the testator's (or intestate's) residuary estate. See IHTM22031[69]
> Consequently you must, in such a case, consider separately the situs of each of the underlying assets.
> For example, the excluded property provisions in s.6(2) IHTA may apply to qualifying securities included in the unadministered estate (IHTM04260)

59.27 Situs of partnership share

The situs of a partnership share may not matter for IHT, because of BPR, but the issue will sometimes arise.

An interest in a partnership is an asset (a chose in action) distinct from the assets of the partnership. It has its own situs distinct from the situs of the partnership assets. HMRC accept this view. The HMRC website POA guidance provides at Appendix 1:

> For IHT purposes ... we do not regard the partnership interest as transparent.

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68 Author's Note: Further consideration will be required for jurisdictions other than England and Wales, especially civil law jurisdictions.

69 See s.91 IHTA.

There are several factors that the court might have used to determine situs. In practice the situs of an interest in a conventional[70] partnership is the place where the partnership business is carried on.[71] This is not necessarily the place where the partners reside: there is no concept here of carrying on business by tacit oversight.[72]

Section 267A IHTA deals with limited liability partnerships:

> For the purposes of this Act and any other enactments relating to inheritance tax—
> (a) property to which a limited liability partnership is entitled, or which it occupies or uses, shall be treated as property to which its members are entitled, or which they occupy or use, as partners,
> (b) any business carried on by a limited liability partnership shall be treated as carried on in partnership by its members,
> (c) incorporation, change in membership or dissolution of a limited liability partnership shall be treated as formation, alteration or dissolution of a partnership, and
> (d) any transfer of value made by or to a limited liability partnership shall be treated as made by or to its members in partnership (and not by or to the limited liability partnership as such).

This deems the LLP's property to be property to which its members are entitled *as partners*. It does not deem the partners to be entitled to the assets, but puts an LLP in the same position as a conventional partnership. An obscure passage in the IHT Manual para 25094[73] suggests that HMRC may not have reached this view, but it seems clear enough.

70 That is, a partnership which is not a limited liability partnership.

71 See *Laidlay v Lord Advocate* (1890) 15 App Cas 482, followed *Commissioner of Stamp Duty v Salting* [1907] AC 449. Further consideration would be needed if the partnership is not governed by English law. I am not sure about the position for a Scots law partnership and would be grateful for any reader who could refer me to relevant authority.

72 See 14.1 (UK resident trader).

73 "A further change is that an interest in a LLP is deemed to be an interest in each and every asset of the partnership, while an interest in a traditional partnership is a 'chose in action', valued by reference to the net underlying assets of the business. This may require you to consider issues of situs of property. In cases of doubt refer to Technical Group (TG) (IHTM01081) for advice."

CHAPTER SIXTY

SITUS OF ASSETS FOR CGT

60.1 Situs of assets for CGT – Introduction

This chapter deals with situs of assets for CGT. For a general introduction to the subject see 59.1 (Concepts of situs). For situs of partnership assets, see 28.7 (Transparency of partnership for CGT).

60.2 Municipal and government shares/debentures

Section 275(1)(d) TCGA provides:

> shares or debentures issued by any municipal or governmental authority, or by any body created by such an authority, are situated in the country of that authority.

The CG Manual provides:

> **12450. Shares and securities**[1]
> (Published 7/94)
> Shares or securities issued by any municipal or governmental authority or by any body created by such an authority are situated in the country of that authority, Section [275(1)(d)] TCGA. This applies to shares and securities issued by such bodies whether they are in registered form or in bearer form.

60.3 Shares or debentures: UK incorporated company

Section 275(1)(da) TCGA provides:

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1 Following the 2005 reforms, the reference to securities should read "debentures". But it is hard to see what difference that makes.

> Subject to para (d) above, shares in or debentures of a company incorporated in any part of the UK are situated in the UK.

It is doubtful whether this rule is consistent with EU law but in practice the issue may not arise.

This rule prevents CGT planning for UK incorporated companies by use of bearer shares and foreign share registers. This was a common practice for many years. The spur to the legislation was probably *Chandrasekaran v Deloitte & Touche* [2004] EWHC 1378 which openly discussed this planning.

If the company is not incorporated in the UK, the intricate combination of statutory and common law rules (discussed below) apply for CGT. It would be more sensible if the rule were that *all* shares/debentures are situate in the place of incorporation.

60.4 Registered shares or debentures: non-UK company

Section 275(1)(e) TCGA provides:

> subject to paras (d) and (da) above, registered shares or debentures are situated where they are registered and, if registered in more than one register, where the principal register is situated.

This is a statutory re-statement of the common law rule[2] but it only applies to foreign incorporated companies.

The CG Manual provides:

> **12451.** (Published 7/94)
> Registered shares and securities[3] other than those dealt with in the previous paragraph are situated where they are registered. This will normally be in the country where the company was incorporated. If they are registered on more than one register then they are located where the principal register is located, Section [275(1)(e)] TCGA. Which register is the principal register is a question of fact.

In relation to debentures (as opposed to shares) there is an apparent

2 See 59.4 (Situs of registered shares).

3 Following the 2005 reforms, the reference to securities should read "debentures". But it is hard to see what difference that makes.

conflict between this rule and the creditor-residence rule.[4] However, that rule is expressly subject to s.275(1)(e) so the place-of-register rule prevails. It follows that there is an important distinction for CGT situs between:

(1) debentures, whose situs is:
 (a) UK if issued by UK incorporated company, or
 (b) (if registered) the place of the register, and
(2) debts which are not debentures, whose situs is the residence of the creditor.

60.5 Meaning of "shares" and "debentures"

Section 275(2) TCGA provides:

> In subsection (1) above—
> (a) in paras (d), (da) and (e), the references to shares or debentures, in relation to a company that has no share capital, include any interests in the company possessed by members of the company, and
> (b) in paras (d) and (e), the references to debentures, in relation to a person other than a company, include securities.

"Debentures" and "securities" are not defined. For a discussion of the meaning of "security", see *Gore-Browne on Companies* para 17.3; *Interests in Securities*, Benjamin, 1st ed., 2000, paras 1.02 and 1.20.

60.6 Bearer shares or debentures: non-UK company

For bearer shares/debentures of foreign incorporated companies, the bearer security rule applies.[5]

The CG Manual provides:

> **12452. Shares and securities** (Published 7/94)
> The Companies Acts allow companies to issue 'share warrants to bearer' or 'stock warrants to bearer' provided the company's Articles of Association allow it. These are commonly called bearer shares and

4 See 60.7 (Ordinary debt).
5 See 59.6 (Bearer documents).

> securities. The name of the owner of such bearer securities is not recorded in the register of the company. They can be sold without any necessity to notify the company. The holder of the warrant is entitled to receive payment of dividends and, provided certain conditions are complied with, to vote at general meetings.
>
> **12453.**
> (Published 7/96)
> The location of bearer securities issued by any body other than those referred to in CG12450[6] is not covered by a specific capital gains rule. Therefore it has to be decided in accordance with general law, see CG12420–12421. General law provides that such securities are located where the certificate is located. As for chattels, the location can change if the certificate is moved in or out of the UK.

The bearer security rule applies for CGT in relation to bearer shares of non-UK incorporated companies. It does not apply to bearer debt securities, where specific CGT rules override the common law rules: see 60.7 (Ordinary debt). But in the common arrangement of debentures of non-UK incorporated companies, where a company owes a single debt to trustees, and investors hold merely an equitable interest in that debt, it is suggested that the investors' right is not a "debt" and therefore dealt with by the bearer security rule, not by the statutory CGT debt rules.

60.7 Ordinary debt

A debt is in some cases a chargeable asset for CGT, so its situs may be relevant for CGT. Section 275(1)(c) TCGA provides:

> subject to the following provisions of this subsection, a debt, secured or unsecured, is situated in the UK if and only if the creditor is resident in the UK.

This reverses the usual common law rule (situs is where the *debtor* is situate). The CG Manual explains:

> **12441.** (Published 7//94)
> The general rule for other debts [non-judgment debts] is that the debt is situated in the UK if and only if the creditor is situated in the UK. This

6 See 59.19 (Securities of international organisations).

applies whether the debt is secured or unsecured, Section [275(1)(c)] TCGA, see CG12445–G12446.

This provision overrides the UK proper law rule and common law rules such as the specialty rule and the bearer security rule. It applies if the creditor is dual resident i.e. resident in the UK and elsewhere. However, it is subject to the rules relating to:

(1) municipal and government securities;[7]
(2) registered debentures of foreign incorporated companies;[8]
(3) debentures of UK incorporated companies;
(4) judgment debts;
(5) bank accounts.

60.8 Securities of international organisation

The CG Manual provides:

> **12470. Securities of International/European Organisations** (Published 7/94)
> Special rules are provided for dealing with securities issued by International and European Organisations.
>
> **12471.** (Published 7/94)
> Section 265 TCGA allows the Treasury to designate for special treatment certain organisations whose membership includes the UK or any of the Communities of which the UK is a member. Once such an organisation has been designated any securities issued by it are deemed for the purposes of CGT to be located outside the UK. The list of organisations that have been designated under this provision is as follows:
>
> - International Bank for Reconstruction and Development
> - Asian Development Bank
> - African Development Bank
> - The European Economic Community
> - The European Investment Bank
> - The European Bank for Reconstruction and Development
> - The European Coal and Steel Community
> - The European Atomic Energy Community
>
> **12472.** (Published 7/94)
> Section 266 TCGA also provides that any security issued by the Inter-American Development Bank shall be treated as located outside the UK for Capital Gains

7 See 60.2 (Municipal and government shares/debentures).
8 See 60.4 (Registered shares or debentures non UK company).

purposes.

60.9 Judgment debt

Section 275(1)(k) TCGA restates the common law rule:

> a judgment debt is situated where the judgment is recorded.

The CG Manual explains:

> **12440. Debts** [January 2005]
> Judgment debts, that is, debts created by the judgments, decrees, etc, of courts of record, are located where the judgment is recorded, Section [275(1)(k)] TCGA.

Obtaining judgment may have the effect of changing situs.

60.10 Bank account

A foreign currency bank account is normally a chargeable asset for CGT.[9] The question therefore arises as to the situs of the account. Section 275(1)(l) TCGA provides:

> a debt which—
> (i) is owed by a bank, and
> (ii) is not in sterling, and
> (iii) is represented by a sum standing to the credit of an account in the bank of an individual who is not domiciled in the UK,
>
> is situated in the UK if and only if
> [a] that individual is resident in the UK and
> [b] the branch or other place of business of the bank at which the account is maintained is itself situated in the UK.

In short, for UK resident foreign domiciled individuals, the situs of a foreign currency account is the situs of the branch.

This restates the common law rule for bank accounts; it is needed because without this provision the situs of the account would be the residence of the creditor (i.e. the account holder).

9 See 36.7.1 (Foreign currency bank account).

In cases where the conditions (i), (ii) and (iii) are not all satisfied, the usual CGT debt rule applies. The moral is that a foreign domiciled UK resident individual should keep chargeable foreign currency in non-UK bank accounts.

60.11 Intangible assets

Section 275A(1) TCGA provides:

> This section applies for the purpose of determining whether the situation of an intangible asset ("asset A") is in the UK if the situation of asset A is not otherwise determined (see section 275B(1)).

Section 275B(1) TCGA provides a commonsense explanation of "not otherwise determined":

> For the purposes of section 275A, the situation of an asset is not otherwise determined if, apart from that section, this Act does not make any provision for determining—
> (a) the situation of the asset, or
> (b) whether the situation of the asset is in the UK.

Thus all the rules in s.275 TCGA have priority to this rule.

60.11.1 *Meaning of "intangible asset"*

Section 275A(2) TCGA provides a commonsense definition of "intangible asset":

> In this section "intangible asset" means—
> (a) intangible or incorporeal property and includes a thing in action, or
> (b) anything that under the law of a country or territory outside the UK corresponds or is similar to intangible or incorporeal property or a thing in action.

This includes policies and bonds, futures and options.

60.11.2 *The UK law rule*

Section 275A(3) TCGA provides:

> If asset A is subject to UK law (see section 275B(2)) at the time it is created, it shall be taken for the purposes of this Act to be situated in the UK at all times.

I refer to this as "the UK law rule".

The expression "subject to UK law" is widely defined in s.275B(2):

> For the purposes of section 275A, an intangible asset is subject to UK law at a particular time if any right or interest which comprises or forms part of the asset is, at that time,—
> (a) governed by, or otherwise subject to, or
> (b) enforceable under,
> the law of any part of the UK.

60.12 Futures and options

60.12.1 *Definitions of "future" and "option"*

Section 275B(3) TCGA incorporates the definitions in para 12(6) to (10) Sch. 26 FA 2002:

> (6) A "future" is a contract for the sale of property under which delivery is to be made—
> (a) at a future date agreed when the contract is made, and
> (b) at a price so agreed.
> (7) For the purposes of sub-para (6)(b) a price is to be taken to be agreed when the contract is made—
> (a) notwithstanding that it is left to be determined by reference to the price at which a contract is to be entered into on a market or exchange or could be entered into at a time and place specified in the contract; or
> (b) in a case where the contract is expressed to be by reference to a standard lot and quality, notwithstanding that provision is made for a variation in the price to take account of any variation in quantity or quality on delivery.
> (8) An "option" includes a warrant.
> (9) A "warrant" is an instrument which entitles the holder to subscribe for shares in a company or assets representing a loan relationship of a company; and for these purposes it is immaterial whether the shares or assets to which the warrant relates exist or are identifiable.
> (10) References to a future or option do not include references to a

> contract whose terms provide—
> (a) that, after setting off their obligations to each other under the contract, a cash payment is to be made by one party to the other in respect of the excess, if any, or
> (b) that each party is liable to make to the other party a cash payment in respect of all that party's obligations to the other under the contract,
>
> and do not provide for the delivery of any property.
>
> Nothing in this sub-paragraph has effect to exclude, from references to a future or option, references to a future or option whose underlying subject matter is currency.

This excludes futures and options, such as financial futures over the FTSE 100 index, which are settled only in cash, rather than by delivery of the underlying subject matter.

I surmise that the purpose of the rules relating to futures and options is to prevent avoidance by shifting value from UK incorporated companies (UK situate for CGT) into futures and options which might (but for these rules) be situate outside the UK. That explains why financial futures are not affected by these rules. But if that is right, the proviso to para 12(10), bringing currency options within the rules, makes no sense in this context.

60.12.2 *"Underlying subject matter"*

This expression is given a commonsense definition by s.275B(4) TCGA:

> For the purposes of section 275A—
> (a) the underlying subject matter of a future is the property which, if the future were to run to delivery, would fall to be delivered at the date and price agreed when the contract is made, and
> (b) the underlying subject matter of an option is the property which would fall to be delivered if the option were exercised.

60.12.3 *Underlying subject matter in existence*

If a future/option is subject to UK law when created, it is UK situate under the UK law rule. Special rules apply to a foreign law future/option. The drafting makes some formal gestures to the modern plain English style, but its structure is so convoluted that one wonders whether the drafter was trying to make a point about it (or perhaps a joke).

Section 275A(4) TCGA provides:

> Subsections (5) to (9) below have effect if asset A—
> (a) is a future or option (see section 275B(3)), and
> (b) is not subject to UK law at the time it is created.

The rule is in s.275A(6) TCGA:

> That rule is that where, in the case of any intangible asset,—
> (a) the asset is a future or option,[10]
> (b) the underlying subject matter (see section 275B(4)) of the asset consists of or includes an asset which is an intangible asset, and
> (c) either—
> (i)[A] that intangible asset is subject to UK law at the time it is created and,
> [B] on the assumption that there were no rights or interests in or over that asset, the situation of that asset would not be otherwise determined, or
> (ii) that intangible asset is treated by this subsection as being so subject at that time,
> the intangible asset mentioned in para (a) above [i.e. the future or option] is to be treated for the purposes of subsection (5) above and this subsection as being so subject at the time it is created.

This then triggers s.275A(5) TCGA:

> If, as a result of the application of the rule in subsection (6) below in relation to asset A or any other asset or assets, asset A falls to be treated as being subject to UK law at the time it is created, it shall be taken for the purposes of this Act to be situated in the UK at all times.

Thus a foreign law future/option over a UK situate underlying intangible asset may itself be UK situate.

EN FB 2005 explains the point of s.275A(6)(c)(ii):

> These rules apply recursively. In any case where there is a "nested sequence" of futures or options in which the underlying subject matter of each contract in the sequence consists of or includes the next contract in the sequence, subsection (5) has effect to provide that the first contract is taken for TCGA purposes to be situated in the UK at all

10 This is otiose, since it repeats s.275A(4); but it does not matter.

times if the [relevant] requirements ... are met in relation to any of the contracts in the sequence.

One might think that s.275A(6)(c)(i)[B] leaves a gap where the situs of the underlying subject matter *would* be otherwise determined. However, that gap is filled by s.275A(8)(b)(i)[B]:

(7) If—
(a) asset A is not taken to be situated in the UK by virtue of subsection (5) above, and
(b) as a result of the application of the rule in subsection (8) below in relation to asset A or any other asset or assets, asset A falls to be treated as being situated in the UK at any time,
it shall be taken for the purposes of this Act to be situated in the UK at that time.
(8) That rule is that where, in the case of any intangible asset,—
(a) the asset is a future or option, and
(b) the underlying subject matter of the asset consists of or includes an asset—
(i) which is, by virtue of
[A] subsection (9) below or of
[B] any provision of this Act apart from this section,
situated in the UK at any time, or
(ii) which is treated by this subsection as being so situated at any time,
the intangible asset mentioned in para (a) above is to be treated for the purposes of subsection (7) above and this subsection as being so situated at that time.

60.12.4 *Underlying subject matter unissued shares or debentures*

Section 275A(7) to (9) TCGA makes provision for the case where the underlying subject matter is unissued shares or debentures:

(9) Where—
(a) the underlying subject matter of a future or option consists of or includes shares or debentures issued by a company incorporated in any part of the UK, but
(b) at the time the future or option is created, those shares or debentures have not been issued,
the underlying subject matter of the future or option, so far as consisting of or including those shares or debentures, is to be taken, for the

> purposes of subsection (8) above, to consist of or include an asset which is situated in the UK at all times.

60.13 Co-ownership

Section 275C TCGA provides:

> (1) This section applies for determining for the purposes of this Act—
> (a) the situation of an interest (see subsection (4)) in an asset, or
> (b) whether the situation of an interest in an asset is in the UK.
> (2) The situation of the interest in the asset shall be taken to be the same as the situation of the asset, as determined in accordance with subsection (3) below.
> (3) The situation of the asset for the purposes of subsection (2) above shall be determined on the assumption that the asset is wholly-owned by the person holding the interest in the asset.
> (4) In this section "interest", in relation to an asset, means an interest as a co-owner of the asset (whether the asset is owned jointly or in common and whether or not the interests of the co-owners are equal).

At first sight it is hard to see the point of this. If an asset is situate in a jurisdiction, how can a share in the asset be situate elsewhere? However, it is relevant to the statutory rules on shares in UK companies. It might be argued that if someone held merely an interest in a bearer share as co-owner, he did not hold a "share" so s.275(1)(da) would not apply and so the common law rule (bearer share situate where certificate is) survived. If that is right, it makes sense that there is no equivalent in IHT to the rule in s.275C.

60.14 Depository receipts

Depository receipts are discussed at 59.8 (Securities held in clearing systems: depository receipts) where I conclude (contrary to the CG Manual statement) that the situs under the common law rule is where the register of the DR is kept, not the situs of the underlying asset. For CGT, however, s.60 TCGA provides:

> (1) In relation to property held by a person as nominee for another person, or as trustee for another person absolutely entitled as against the trustee, or for any person who would be so entitled but for being an

> infant or other person under disability (or for 2 or more persons who are or would be jointly so entitled), this Act shall apply as if the property were vested in, and the acts of the nominee or trustee in relation to the property were the acts of, the person or persons for whom he is the nominee or trustee (acquisitions from or disposals to him by that person or persons being disregarded accordingly).
> (2) It is hereby declared that references in this Act to any property held by a person as trustee for another person absolutely entitled as against the trustee are references to a case where that other person has the exclusive right, subject only to satisfying any outstanding charge, lien or other right of the trustees to resort to the property for payment of duty, taxes, costs or other outgoings, to direct how that property shall be dealt with.

Does the depository hold as bare trustee for the investors? Whether this is the case will depend on the terms of the agreement with the depositary. If so, the effect of s.60 TCGA is to treat the owner of the DR as owner of the underlying asset, so this reverses the common law rule.[11] So the view expressed in the CG Manual may be correct though for different reasons to the reasons given there.

60.15 Insurance policy

The situs of policies and bonds rarely matters for CGT, because of the relief for policies. UK policies will be UK situate under the UK law rule and for others the common law rule will apply.[12]

60.16 Land

Section 275(1)(a) TCGA provides:

> the situation of rights or interests (otherwise than by way of security) in or over immovable property is that of the immovable property.

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11 If the DR is subject to UK law, and s.60 TCGA did not apply (contrary to the view taken here) then the common law situs rule will be overridden for CGT by the UK law rule: see 60.11 (Intangible assets). However, a DR is not normally made subject to UK law.

12 A policy is not a debt for the purposes of the CGT place-of-creditor rule.

The CG Manual provides:

> **12430. Land and buildings**
> (Published 7/94)
> Land and buildings are located in the country where they are found. This applies to all rights and interests in the land and buildings. It will therefore apply to leases of land, tenancies etc, Section [275(1)(a)] TCGA.

60.17 Chattels

Section 275(1)(b) TCGA provides:

> subject to the following provisions of this subsection, the situation of rights or interests (otherwise than by way of security) in or over tangible movable property is that of the tangible movable property.

The CG Manual provides:

> **12435. Chattels**
> (Published 7/94)
> Items of tangible moveable property (chattels) are located where they are found at any point in time. This applies to all rights and interests over such assets also. Therefore a lease of a chattel can change from being located in the UK to being located elsewhere if the chattel is removed from the UK to another country, Section [275(1)(b)] TCGA.

For the position of temporarily exported chattels, see 59.20 (Chattels).

60.18 Ships and aircraft

Section 275(1)(f) TCGA provides:

> a ship or aircraft is situated in the UK if and only if the owner is then resident in the UK, and an interest or right in or over a ship or aircraft is situated in the UK if and only if the person entitled to the interest or right is resident in the UK.

The CG Manual provides:

> **12480. Ships and aircraft**
> (Published 7/94)
> Contrary to the general rules of international law,[13] for capital gains purposes the location of a ship or aircraft does not depend on its country of registration. Instead the ship or aircraft is located in the UK if and only if the owner is resident in the UK. Similarly any interest or right in or over the ship or aircraft is located in the UK if and only if the owner of the interest or right is resident in the UK, Section [275(1)(f)] TCGA.

This effectively disapplies the CGT remittance basis since a UK resident's ships and aircraft are UK situate; and a non-resident is generally outside the scope of CGT.

60.19 Goodwill

Section 275(1)(g) TCGA provides:

> the situation of good-will as a trade, business or professional asset is at the place where the trade, business or profession is carried on.

The CG Manual provides:

> **12490. Goodwill**
> (Published 7/94)
> Goodwill which is an asset of a trade, profession or vocation is located where the trade, profession or vocation is carried on, Section [275(1)(g)] TCGA. If the trade etc is carried on in more than one country part of the goodwill appropriate to the part of the trade etc carried on in any one country should be treated as located in that country.

60.20 Interest under bare trust or nomineeship

The interest of a beneficial owner in property held by a nominee or bare trustee is situate where the underlying asset is situate: s.60 TCGA reinforces the common law rule on this point.[14]

For unit trusts see 27.4.2 (Situs of unit for CGT).

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13 The Manual's view (that under international law ships and aircraft are situate where registered) is erroneous: see 59.21 (Ships and aircraft).

14 See 59.24 (Interest under bare trust or nomineeship).

60.21 Equitable interest under a substantive trust

The situs of an equitable interest under a substantive trust is only rarely relevant for CGT, but it may matter, e.g. in the case of a purchased interest or an interest in a non-resident trust. If the trust is "subject to UK law" as defined, the interest will be situate in the UK. This clearly includes the case of a trust with a UK governing law; it may arguably apply to any trust with UK trustees. In other cases the common law rules will apply.

60.22 Intellectual property

Section 275(1) TCGA provides:

> (h) patents, trade marks, registered designs and corresponding rights are situated where they are registered, and if registered in more than one register, where each register is situated, and licences or other rights in respect of any such rights are situated in the UK if they or any right derived from them are exercisable in the UK,
> (j) copyright, design right, franchises, and corresponding rights, and licences or other rights in respect of any such rights, are situated in the UK if they or any right derived from them are exercisable in the UK.

"Corresponding rights" is defined in s.275(3) TCGA:

> In subsection (1) above, in each of paras (h) and (j), "corresponding rights" means any rights under the law of a country or territory outside the UK that correspond or are similar to those within that paragraph.

This will not often concern the UK resident foreign domiciliary. It is important for non-residents carrying on a trade in the UK through a permanent establishment, who are (in short) subject to CGT on UK situate trading assets: s.10 TCGA. Intellectual property is (uniquely) capable of being situate for CGT purposes in more than one jurisdiction.

60.23 Unadministered estate of deceased person

If the estate is governed by UK law, it is UK situate for CGT. Other estates are governed by the common law rule.[15]

15 See 59.26 (Unadministered estate of deceased person).

CHAPTER SIXTY ONE

DISCLOSURE AND COMPLIANCE

61.1 Standards of disclosure and mistake

61.1.1 *Standards of care: culpability of mistakes*

It is helpful first to define some terminology and draw some distinctions. Errors may be classified by certain standards:

"An honest error" is one where the maker meets the standard of honesty.
"A non-negligent error" is one where the maker meets the standard of reasonable care.
"A reasonable-excuse error" is one for which the maker has a reasonable excuse. This is similar to a non-negligent error, but perhaps it reflects a higher standard: it is perhaps possible to envisage an error which is not negligent but for which one still cannot find a reasonable excuse. But the difference (if any) is only a matter of nuance and for most purposes they are the same.

The minimum level of care required is that of reasonable care, ie if there is a mistake in a return (or any other document given to HMRC) the error is honest and non-negligent.

61.1.2 *Levels of disclosure*

Taxpayers disclosure may be classified by various standards:

"**Minimum disclosure"** – the minimum required by statute.
"Above-minimum disclosure" meeting some higher standard above that minimum. This is a (deliberately) loose expression since (in the absence of context) a variety of standards might be applied. One particular

standard (discussed below) I call **"Veltema-disclosure"** but there can be other standards.

"Full disclosure" (in the absence of context) is not an apt expression, and I prefer to avoid it, because one cannot disclose *everything*: that is not practical. Indeed even to try would swamp HMRC with information so they could not identify what is relevant. HMRC are themselves aware of this. SP 1/06 provides:

> 9. A taxpayer can further restrict the opportunity for discovery [assessments] by providing enough information for an HMRC officer to realise within the enquiry period that the self-assessment is insufficient. However taxpayers are encouraged to submit the minimum necessary to make disclosure of an insufficiency. The Veltema judgement does not require the provision of enough information to quantify the effect on the assessment. Information will not be treated as being made available where the total amount supplied is so extensive that an officer 'could not have been reasonably expected to be aware' of the significance of particular information and the officer's attention has not been drawn to it by the taxpayer or taxpayer's representative.

61.2 Self-assessment tax return: minimum disclosure

This section discusses general principles. See also 17.15 (Disclosure of TAA issues in tax return) and 21.45 (Motive defence claim in tax return).

A tax return is a series of questions, and the statutory duty of taxpayers (and advisers) is simply to answer them. The answers should be honest and non-negligent. That is, one cannot necessarily avoid errors, but any errors in the return should be honest and non-negligent.

The standard of honesty is the ordinary standard of reasonable and honest people.[1] In practice debate normally focusses on neglect.

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1 But what is that standard? It ultimately depends on the view of the judge or jury as finders of fact. Did Pepys reflect those standards when he wrote in his diary for 10 December 1660:

> "This afternoon there was a Couple of men with me, with a book in each of their hands, demanding money for polemony; and I overlooked the book and saw myself set down *Samuel Pepys, gent.,* 10*s* for himself and for his servants 2*s*. Which I did presently pay without any dispute; but I fear I shall not escape so, and therefore I have long ago laid by 10*l:* for them; but I think I am not bound to discover myself"?

The point of the entry is that he was liable to pay £10 under the Act (12 Car. II c.9)

61.3 Neglect

61.3.1 *Significance of neglect*

Neglect is relevant to time limits of assessment and to penalties.

As far as time limits are concerned, it is convenient to read s.34(1) and 36(1) TMA together:

> **34(1)** Subject to the following provisions of this Act, and to any other provisions of the Taxes Acts allowing a longer period in any particular class of case, an assessment to income tax or capital gains tax may be made at any time not more than 4 years after the end of the year of assessment to which it relates.[2] ...
> **36(1)** An assessment on any person ... in a case of making good to the Crown a loss of income tax or capital gains tax attributable to his fraudulent or negligent conduct or the fraudulent or negligent conduct of a person acting on his behalf may be made at any time not later than 20 years after the 31 January next following the year of assessment to which it relates

In short, there is normally an (approximately) 4-year limit on assessments. In the case of neglect, assessments may be made up to 20 years.

The taxpayer may be subject to penalties if he is guilty of neglect. In penalty matters the neglect must (in short) be personal neglect of the taxpayer, not of his agents (though it is of course possible for both taxpayer and agent to be guilty of neglect).[3]

61.3.2 *Meaning of "neglect"*

Enquiry Manual para 5125 correctly provides:

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as an esquire. Pepys' good fortune continued under the next poll tax: The entry of 20 March 1667 reads:

> "I ... assessed by the late Pole-bill, where I am rated at an Esquire; and for my office, all will come to about 50*l* – but not more then I expected, nor so much by a great deal as I ought to be for all my offices – so I shall be glad to escape so."

2 This is the text as prospectively amended by the FA 2008 but the amendment is not relevant for the purposes of the discussion here.

3 Para 18(3) Sch 24 FA 2007.

Culpability: Neglect, Negligence and Negligent Conduct
The terms are interchangeable.

The penalty provisions in Sch 24 FA 2007 use the word "careless", defined to mean "failure to take reasonable care";[4] this is just a Plain English synonym of "negligence" or "neglect".

After referring to a now repealed statutory provision the Manual continues:

> Baron Alderson in *Blyth v Birmingham Waterworks Co,* 1856, 11 Ex 781, p784, which was concerned with the law of tort says
>
> > "Negligence is the omission to do something which a reasonable man, guided upon those considerations which ordinarily regulate the conduct of human affairs, would do, or doing something which a prudent and reasonable man would not do. The defendants might be liable for negligence, if, unintentionally, they omitted to do that which a reasonable person would have done, or did that which a person taking reasonable precautions would not have done."

This definition will do as well as any other.

The question must be decided in the light of the position as it was at the relevant time without the benefit of hindsight. The fact that a view later turns out to be mistaken does not show that it was negligent to form that view. Otherwise any judge whose decision is reversed on appeal would be guilty of neglect and how often does that happen! The onus of proof generally rests on HMRC to prove negligence. An allegation of neglect is a serious one and it should not be lightly made. I stress these points because HMRC ignore them and allege neglect as a matter of course, whenever neglect is necessary to justify out of time assessments.[5]

Depending on which statutory provision is in point, it may be necessary to ascertain:

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4 Para 3 Sch 24 FA 2007.

5 See eg International Manual which contains this revealing and extraordinary statement:
"268520. Assessing time limits [February 2008]
… If we come to the reasonable conclusion that there is a PE, or that the company is resident in the UK, prima facie there has been negligent conduct in the failure to notify."

(1) whether the taxpayer is guilty of neglect; or
(2) whether the taxpayer's agent is guilty of neglect.

61.3.3 *The standard of care: taxpayers*

A taxpayer who is not an expert in taxation must leave technical tax issues to his professional advisers. When tax law is complicated a properly represented taxpayer cannot be expected to identify his advisers mistakes. So where there are technical errors of law, the issue is normally whether the taxpayer's professional advisers have been guilty of neglect. HMRC agree (if grudgingly):

> A taxpayer who
> [1] goes to an ostensibly competent professional adviser,
> [2] provides a full and accurate account of the facts,
> [3] checks that advice to the limit of his or her ability and competence,
> [4] and then follows the agent's advice (or signs the return prepared on that basis)
> has not been negligent. He or she has taken reasonable care. If it turns out that the agent has made a careless error in giving the advice or in preparing the tax return the taxpayer who has taken reasonable care will not be penalised.[6]

This wording is somewhat overfavourable to HMRC, at [2] and [3] which (depending on what nuance one puts on the expressions used) do seem to exceed a requirement of reasonable care. But the basic point made is correct.

An interesting question is what the taxpayer should do if his advisers disagree. A safe course then (if the amounts involved make this reasonable) is to seek the advice of counsel, or more senior counsel, or a QC, but what is to be done if two tax QCs disagree or if the amounts do not justify that expense? It is suggested that the correct course is as follows:

(1) The individual must ask himself whether one view or the other is obviously or glaringly wrong. However it is not to be expected that

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6 "Modernising Powers, Deterrents and Safeguards: Working with Tax Agents" 22 April 2009, accessible *www.hmrc.gov.uk/budget2009/tax-agent-6440.pdf*

this will often provide a solution.

(2) Subject to that, the individual can in principle follow whichever view suits him, provided that the person whose advice is adopted is suitably experienced, has seen the contrary advice and maintains his view. Then (even if the practitioner whose view is adopted turns out to be wrong) any error is non-negligent and a reasonable-excuse error.

61.3.4 *The standard of care: tax practitioners*

The question then is what reasonable tax practitioners should do in advising or completing a tax return for a client. The standard of care is that to be expected of a reasonable practitioner.[7]

A solicitor or accountant is entitled to rely on advice given by an appropriate expert counsel (provided it is not obviously or glaringly wrong). A person who acts in this way is not negligent.[8] This rule applies in the completion of a tax return. So where counsel has advised, HMRC would normally need to allege that counsel is guilty of neglect in order to make an out of time assessment.

What should a practitioner do if the law is so unclear that he is unable to form a view? Common examples include residence and the source of interest: in many cases the only honest answer to the question of how a court would decide is “I don’t know” or “toss a coin”. In such cases the proper course is to complete the tax return on whichever view best suits the client.

A trickier question is where professional views differ between view A and view B, the practitioner prefers view A, but view B suits the client. It is suggested the practitioner can advise the client to fill in his return on view B. Take, for example, the old chestnut problem of GWR and trusts. In my view there is no IHT charge on the death of a deemed domiciled individual who has a GWR in an excluded property trusts. Some practitioners (I think, a minority) take the view that there is a charge. Should they really advise their clients to complete the return on that basis?

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7 Of course, the adviser's duty is not merely (merely?) to understand the law. He/she must explain it, record it in writing, and identify the risk factors to the client. Is this so obvious that it is unnecessary to say? It is not: *Chandrasekaran v Deloitte & Touche Wealth Management* [2004] EWHC 1378 at [72].

8 *Locke v Camberwell Health Authority* [1991] 2 Med LR 249 accessible *www.kessler.co.uk*.

I would have thought not. If that were wrong, then the best advice one could give would be to change advisers, which can hardly be right.

61.4 Significance of reasonable excuse

It is not possible to give a full list. The most important is s.59C TMA which imposes a 5% surcharge on tax paid more than 28 days late and another 5% on tax paid more than 6 months late. It is not a requirement that the taxpayer or his agent be guilty of neglect. (This is no doubt why the term used is "surcharge" and not "penalty".) Instead there is a defence for a taxpayer with a "reasonable excuse".

61.5 Advantages of above-minimum disclosure

This section considers whether a tax return should contain more than the minimum disclosure of answering the questions asked. The "white box" section of a tax return "Any other information" is designed for this purpose, or material may of course be put in a covering letter.

Any such disclosure is strictly voluntary. Everyone who is responsible for completing tax returns has to ask questions and decide on the answers. If an answer is reached, there is in general no obligation to disclose this process of reasoning to HMRC. Failure to do so does not render answers in the return (even if they turn out to be wrong) to be dishonest or negligent errors. The CIOT agree:

> In the preparation of a tax return, there is no duty to provide more information to the tax authorities than the return requires simply because some pieces of information known to the member might support a different tax treatment from that which the member, after due consideration of all the information available to him, honestly considers to be the tax treatment.[9]

9 The Professional Conduct in Relation to Taxation, 2004, para 3.10 accessible *www.tax.org.uk*
The Keith Committee recommended that taxpayers' doubts should be disclosed to HMRC but the recommendation was rightly rejected as impractical: see Committee on Enforcement Powers of Revenue Departments (1983) Cmnd 8822 para 7.3.6 and HMRC consultation papers "The Inland Revenue and the Taxpayer" and "Keith: Further Proposals" (1988).

The fact that there is a possibility that the courts might disagree with an adviser's view does not in itself require any disclosure. Such a possibility almost always exists, even if the law seems clear: decisions such as *Rysaffe* and *Grimm v Newman* (happily corrected on appeal) and *Phizackerley* (not appealed) illustrate the uncertainties – or (which comes to the same thing) the lottery element in litigation.

Voluntary disclosure may be desirable for any one or more of the following reasons:

(1) It may curtail HMRC's enquiry period.
(2) It may facilitate good relations with HMRC.
(3) It may help avoid later allegations of bad faith, which might later arise if the view taken turns out to be in error, and tax is due:
 (a) Allegations of dishonesty (based on a suspicion that the taxpayer might be relying on HMRC not finding out the facts).
 (b) Allegations of neglect.
 (c) Allegations of no reasonable excuse.

61.6 Voluntary disclosure to curtail enquiry period

61.6.1 *IT and CGT enquiry*

HMRC usually have 12 months in which to begin an enquiry into a tax return. However, s.29 TMA provides an extension of time in certain cases:

> (1) If an officer of the Board or the Board discover, as regards any person (the taxpayer) and a year of assessment—
> (a) that any income which ought to have been assessed to income tax, or chargeable gains which ought to have been assessed to capital gains tax, have not been assessed, ….
>
> the officer or, as the case may be, the Board may, subject to subsections (2) and (3) below, make an assessment in the amount, or the further amount, which ought in his or their opinion to be charged in order to make good to the Crown the loss of tax. ….
>
> (3) Where the taxpayer has made and delivered a return under section 8 or 8A of this Act in respect of the relevant year of assessment, he shall not be assessed under subsection (1) above—
> (a) in respect of the year of assessment mentioned in that subsection; and
> (b) in the same capacity as that in which he made and delivered the return,
>
> unless one of the two conditions mentioned below is fulfilled.

> (4) The first condition is that the situation mentioned in subsection (1) above is attributable to fraudulent or negligent conduct on the part of the taxpayer or a person acting on his behalf.

The first condition will not be satisfied in the absence of fraud or neglect. That takes us to the second condition:

> (5) The second condition is that at the time when an officer of the Board—
> (a) ceased to be entitled to give notice of his intention to enquire into the taxpayer's return under section 8 or 8A of this Act in respect of the relevant year of assessment; or
> (b) informed the taxpayer that he had completed his enquiries into that return,
> the officer could not have been reasonably expected, on the basis of the information made available[10] to him before that time, to be aware of the situation mentioned in subsection (1) above.

The advantage of voluntary disclosure is that HMRC cannot (after the one-year period has passed) make any further enquiries into the return. If a taxpayer wants security that the matter is closed after one year, therefore, it would be necessary to disclose relevant facts. I refer to disclosure which meets the requirements of s.29(5) as **"*Veltema*-disclosure.**"

Taxpayer are entitled to weigh up the advantages of *Veltema*-disclosure

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10 Section 29(6) TMA provides:
"For the purposes of subsection (5) above, information is made available to an officer of the Board if—
(a) it is contained in the taxpayer's return under section 8 or 8A of this Act in respect of the relevant year of assessment (the return), or in any accounts, statements or documents accompanying the return;
(b) it is contained in any claim made as regards the relevant year of assessment by the taxpayer acting in the same capacity as that in which he made the return, or in any accounts, statements or documents accompanying any such claim;
(c) it is contained in any documents, accounts or particulars which, for the purposes of any enquiries into the return or any such claim by an officer of the Board, are produced or furnished by the taxpayer to the officer, whether in pursuance of a notice under section 19A of this Act or otherwise; or
(d) it is information the existence of which, and the relevance of which as regards the situation mentioned in subsection (1) above—
(i) could reasonably be expected to be inferred by an officer of the Board from information falling within paras (a) to (c) above; or
(ii) are notified in writing by the taxpayer to an officer of the Board."

(curtailing the enquiry period) against the disadvantages (possible costs).

61.6.2 *Veltema standard of disclosure*[11]

The Enquiry Manual provides:

> **3260. Made Available**
> In *Langham v Veltema* 76 TC 259, Auld LJ considered two issues relating to s 29(6).
> The first issue was ‘whether awareness or inference of actual insufficiency is required to negative the condition, or would awareness that it was questionable do’.
> The second issue was ‘what is the relevant information before the Inspector on the basis of which he could be said to have been reasonably expected to be aware of an insufficiency’.
> ***First issue***
> In addressing this Auld LJ concluded:
>
>> ‘.. it is plain from the wording of the statutory test in s 29(5) that it is concerned .... with what he could have been reasonably expected to be aware of. It speaks of an Inspector’s objective awareness, from the information made available to him by the taxpayer, of ‘the situation’ mentioned in s 29(1), namely an actual insufficiency in the assessment. ...
>> It is a mark of the way in which the subsection provides an objective test of awareness of insufficiency, expressed as a negative condition in the form that an officer ‘could not have been reasonably expected ... to be aware of the insufficiency. It also allows as s 29(6) expressly does, for constructive awareness of insufficiency, that is, for something less than an awareness of an insufficiency, in the form of an inference of insufficiency ’.
>
> ***Second issue***
> Auld LJ considered:
>
>> ‘It seems to me that the key to the scheme is that the Inspector is to be shut out from making a discovery assessment under the section only when the taxpayer or his representatives, in making an honest and accurate return or in responding to a Section 9A enquiry, have clearly alerted him to the insufficiency of the assessment in question.’

11 See “Discovery Assessments– The Consequences of the Decision in *Corbally v Stourton* 12 PTPR 45 (Keith Gordon).

There is more HMRC guidance in SP 1/06. This comments on valuation and accountancy issues (not discussed here) and then provides:

> ***Taking a Different View***
> 18. It is open to a taxpayer properly informed or advised to adopt a different view of the law from that published as HMRC's view. To protect against a discovery assessment after the enquiry period, the return or accompanying documents would have to indicate that a different view had been adopted. This might be done by comments to the effect that the taxpayer has not followed HMRC guidance on the issue or that no adjustment has been made to take account of it. This would offer an opportunity to HMRC to take up the return for enquiry. It is not necessary to provide all the documentation that HMRC might need to quantify that insufficiency if an enquiry into the Return is made.
> 19. Provided the point at issue is clearly identified and the stance adopted is not wholly unreasonable, the existence of an under-assessment or insufficiency is demonstrated by the statement that a different view of the law has been followed. In these circumstances the taxpayer achieves finality if no enquiry is opened within the statutory time limit.

61.6.3 *IHT: voluntary disclosure to curtail enquiry*

The IHT rules are differently worded (and much more concise) but the standard of disclosure is similar. A certificate of discharge discharges "all persons from any further claim for the tax on the value transferred by the chargeable transfer concerned". See s.239(3) IHTA. However, s.239(4) provides:

> A certificate under this section shall not discharge any person from tax in case of fraud or failure to disclose material facts. ...

61.7 Above-minimum disclosure for sake of good relations with HMRC

CIOT Professional Conduct in Relation to Taxation[12] provides:

> "It may be in the client's best interest to furnish more information than

12 Para 3.10, accessible *www.tax.org.uk*

> he is strictly required to do because this is likely to lead to a more reasonable approach by the tax authorities, thereby saving money and time in the long run ..."

The CIOT are tentative (note the *may*) and the validity of the point is not easy to assess: it may vary from client to client[13] and from time to time.

It seems to me that the only tangible incentive for above-minimum disclosure is to curtail the enquiry period, and obtaining "a more reasonable approach by the tax authorities" is uncertain, unquantifiable, unenforceable and ultimately chimerical. But readers who deal directly with HMRC on a daily basis will be in a better position than I am to form a view on this issue, and this is (understandably) an attitude that HMRC wish to encourage.[14]

This debate should be seen in the context of a broader policy debate of the correct relationship between the Revenue and the taxpayer. The traditional view has been that this relationship should be characterised by adherence to rules (substantive tax rules and procedural rules such as courtesy, honesty and efficiency) and it is at heart adversarial. The interests of HMRC and taxpayer are distinct.

A rival (and more recent) view that the relationship should be a mutual one, taxpayer and state working together in harmony to achieve a common goal, to ascertain the right amount of tax, something defined partly in rules and partly in a more insubstantial spirit of the rules (of which one suspects HMRC consider themselves the final arbitrator.) This raises factual questions of whether HMRC and taxpayers actually regard this as their relationship, and the political and moral questions of whether they should do so, or the extent to which they should do so, are important questions but they lie beyond the scope of this book.

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13 The trade-off may be different for large businesses who have a specific "client relationship manager", where HMRC expressly offer the carrot of "far fewer interventions" in return for behaviour which meets the HMRC low risk criteria; and, conversely, the stick of "more intensive scrutiny" for "high risk customers": see HMRC Approach to Compliance Risk Management for Large Business, March 2007, accessible *www.hmrc.gov.uk/budget2007/large-business-riskman.pdf.*

14 See comments on the "enhanced relationship" in the OECD Study into the Role of Tax Intermediaries, 2008, *www.oecd.org/dataoecd/28/34/39882938.pdf* and the OECD's "Engaging with High Net Worth Individuals on Tax Compliance" (May 2009); *www.oecd.org/dataoecd/5/25/42798312.pdf.*

61.8 Above-minimum disclosure to avoid allegations of bad faith

Disclosure may be sensible to help avoid allegations of bad faith, which might later arise if the view taken turns out to be in error, and tax is due: allegations of dishonesty, neglect or lack of "reasonable excuse" Cases where disclosure is needed for this reason are rare, but examples are:

(1) Where the taxpayer has carried out a complex, artificial, and aggressive tax avoidance scheme. In such a case (even though it is reasonably considered the scheme should succeed) full disclosure of the transactions should be made so HMRC have a proper opportunity to review the matter. In practice such cases will now generally be caught by the tax avoidance scheme disclosure rules so the issue of disclosure on a tax return does not arise.
(2) Where the taxpayer is taking a view which is contrary to a HMRC view which has been formally published in a SP or RI. The same applies if the HMRC view is clearly known from more informal sources, such as the HMRC Manuals, or informally published correspondence, unless the HMRC view expressed is fairly clearly wrong.
(3) Where the adviser is following a view in the profession which he himself does not share.

That should be regarded as best practice rather than a requirement.

61.9 IHT reporting requirement on creation of settlement

Section 218(1) IHTA provides:

> Where any person, in the course of a trade or profession carried on by him, other than the profession of a barrister, has been concerned with the making of a settlement and knows or has reason to believe—
> (a) that the settlor was domiciled in the UK, and
> (b) that the trustees of the settlement are not or will not be resident in the UK,
> he shall, within three months of the making of the settlement, make a return to the Board stating the names and addresses of the settlor and of the trustees of the settlement.

The duty of disclosure rests on a person ("the practitioner") acting in the course of his trade or profession. The duty rests on the firm or company acting and not directly on its employees.

Barristers are exempt. The reason must be that they will usually be instructed by others who are subject to the duty.

The practitioner must be concerned with the making of a settlement. This would include not only solicitors who might draft the settlement but other advisers who advise in relation to the creation of a settlement, even if the actual execution of the settlement were delegated to foreign advisers.

The practitioner might advise on the matter generally, leaving the client to take whatever action he wishes in light of the advice, perhaps in conjunction with the trustees; in such circumstances he is probably not "concerned with the making of a settlement"; this presupposes the settlement had been established. What if the client had decided against a non-resident settlement after all or wanted to think about it? The practitioner may not know what the client eventually decided to do. The obligation under s.218 must be restricted to those who are able to provide the relevant information.

The practitioner must know or have reason to believe that the settlor is domiciled in the UK. A settlement may have more than one settlor.[15] Suppose one settlor is domiciled in the UK but the other is not. Does the reporting requirement arise? On a literal construction one could not say "the settlor" is UK domiciled and the reporting requirement would not arise. A purposive construction suggests that the duty does arise. That is the better view at least if the foreign domiciled settlor only provides a nominal amount. A practitioner should err on the side of caution.

A question also arises about the time when the settlor's domicile is relevant. Section 218 merely says that it applies if the settlor *was* domiciled in the UK. Does this mean domiciled in the UK at the time the settlement was made? Or does it mean that the settlor had at any time been domiciled in the UK? Context and common sense dictate that the provision is referring to the domicile of the settlor at the time the settlement was made because that is the date that matters for IHT.

IHT Manual para 42993 [June 2007] correctly provides:

15 "Settlor" for this purpose has the usual IHT meaning: see 58.1 (Who is the settlor?). The separate settlements fiction does not apply for this purpose: see 46.4 (The separate settlements fiction).

Where settlor is a company
A s.218 notice is still required because s.218 refers to settlors domiciled in the UK

- 'settlor' in relation to a settlement includes any person by whom the settlement was made (s.44 IHTA)
- In terms of the Interpretation Act 1889 Rule 19 'the expression person shall, unless the contrary appears, include any body of persons corporate or unincorporate'[16]
- In general a company is domiciled where it is registered – *Gasque v IRC* [1940] 2 KB 80.

So where a non-UK resident [Employee Benefit Trust] is established by a company registered in the UK a s.218 notice is mandatory.

The person must know or have reason to believe that the trustees of the settlement are not or will not be resident in the UK

In marginal cases the practitioner may be placed in difficulty. It may be necessary in some cases to disclose the creation of the settlement to HMRC out of caution.

There is no requirement under s.218 to notify the amount or nature of the settled property. However, HMRC have power in s.219 IHTA to require information to be provided by "any person" and they would know from the notification to whom further enquiries could be directed.

Sch. 5A TCGA imposes overlapping reporting requirements relating to non-resident settlements. But s.218 IHTA is wider in some respects. It applies to settlements which are not necessarily non-resident under the CGT rule.[17] Third, the CGT duty is imposed on the settlor. The IHT duty is on the professional advisers.

61.9.1 *Non-resident practitioner*

It is suggested that no duty will arise on foreign practitioners who have no UK connection; the usual territorial limitation must apply: see *Clark v Oceanic* 56 TC 183. At first sight the requirement that the settlor is domiciled in the UK is sufficient to meet the territorial requirement so that no further territorial limitations should be implied. But the domicile

16 The text is 30 years out of date, since the reference should now be to Sch. 1 Interpretation Act 1978, but the point is still valid.

17 For IHT Trust residence, see 4.13 (Trust residence for IHT).
This is quite different from the IT/CGT definition.

connection may be a faint one. Suppose an individual leaves the UK in 2000 and settles in the USA, and in 2003 he makes a settlement. The individual may still be deemed domiciled in the UK, but it is not realistic to expect the US practitioner to file a s.218 return (particularly having regard to the fact that the USA IHT DTT provides IHT exemption).

61.9.2 *Penalty for failure to disclose*

Failure to make the return gives rise only to a nominal penalty.[18] More seriously, the practitioner faces criminal liability for fraud on HMRC or conspiracy to defraud if:

(1) the practitioner dishonestly fails to disclose in breach of the duty to do so; or
(2) any person dishonestly agreed with another practitioner or a client that there shall be no disclosure in breach of the duty to do so.

61.10 Reporting on death of foreign domiciled individual

I consider here the reporting duty of personal representatives on the death of an individual not domiciled in the UK. The legislation draws a distinction between:

(1) "**excepted estates**"; and
(2) "**ordinary estates**"; I use this term to describe an estate which is not an "excepted estate".

61.10.1 *Ordinary estates*

Section 216(1) IHTA provides (so far as relevant):

> Except as otherwise provided by this section or by regulations under section 256 below, the personal representatives of a deceased person ... shall deliver to the Board an account specifying to the best of his knowledge and belief all appropriate property and the value of that property.

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18 Section 245A(1) IHTA 1984.

"Appropriate property" is defined in s.216(3) IHTA which provides (so far as relevant):

> Subject to subsections (3A) and (3B) below,[19] where an account is to be delivered by personal representatives ... the appropriate property is—
> (a) [i] all property which formed part of the deceased's estate immediately before his death
> [ii] (or would do apart from s.151A(3)(b) or 151C(3)(b) above),
> [iii] other than property which would not, apart from section 102(3) of the Finance Act 1986, form part of his estate; and
> (b) all property to which was attributable the value transferred by any chargeable transfers made by the deceased within seven years of his death.

Excluded property does not form part of a person's estate immediate before death, so there is no statutory duty to disclose details of excluded property in a person's estate on death. Nevertheless Question 22 of HMRC form IHT 401 asks:

> Did the deceased leave any assets outside the UK? If yes give approximate value.

There is no legal duty to supply this information.[20] But refusal to answer the question may give rise to further enquiries.

There is no duty to disclose GWR under this section: s.216(3)(a)[iii]; but see 45.17 (Planning and disclosure).

There is no statutory duty to disclose details of gifts of excluded property which the deceased made before death. (The gifts do not fall within s. 216(3)(b) IHTA since a gift of excluded property is not a transfer of value.) However the IHT Account (form IHT 400 September 2008) Question 30 provides:

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19 Subsections (3A) and (3B) are not relevant here.

20 HMRC form D2 (Notes, 12/05) tacitly recognised this:

> "*If the deceased was domiciled outside the UK when they died, any assets they owned abroad will not be liable to inheritance tax. Even so, you can help us to deal with this estate more quickly if you can give us a rough idea of the value of all of the deceased's estate outside the UK.*"

I have not found a similar comment in the current forms which were revised in 2008.

> **Gifts and other Transfers of Value:** Did the deceased make any lifetime gifts or other transfers of value on or after 18 March 1986?

It is considered that the reference in the question to "gifts" means gifts which are transfers of value so that it is proper to answer "no" even if the deceased made gifts of excluded property. The guidance in IHT 400 Notes September 2008 shows that the question is not read literally:

> **Gifts and other transfers of value**
> You can enter 'No' and do not need to provide any details if the only gifts made by the deceased were:
> - to their husband, wife or civil partner and spouse or civil partner exemption applies
> - outright gifts to any individual which do not exceed £250 in any one year. (These will be covered by the small gifts exemption.)
> - outright gifts to any individual of money or listed stocks and shares that are wholly covered by the annual and/or gifts out of income exemptions
> - outright gifts made regularly from income that did not exceed £3,000 in total each year.
>
> These exemptions are detailed on page 72 of this guide. If the deceased had made any other gifts or 'transfers of value' since 18 March 1986, including transfers into trust, payment of insurance premiums for the benefit of another person, advances out of a trust fund or any assets that were taken out of a trust before death, you must fill in Schedule IHT403 *Gifts and other transfers of value*. In general, a 'transfer of value' is any transaction where the deceased did not receive full value in exchange.

Question 45 IHT 400 provides:

> **Assets held in trust**: Did the deceased have any right to benefit from any assets held in trust (including the right to receive assets held in a trust at some future date)? No/Yes – Use Schedule IHT418.

The word "right" only includes fixed interests, it is not apt to describe discretionary trusts. But it appears that "right to benefit" here is used (confusingly) to mean a right to an estate interest in possession. IHT 400 Notes provides:

> ***Schedule IHT418 Assets held in trust***
> You must complete Schedule IHT418 if the deceased had an interest in

possession and the trust is one of the following.
• A trust that was set up before 22 March 2006 from which the deceased was entitled to benefit.
• An immediate post-death interest.
• A disabled person's interest.
• A transitional serial interest.

This would include an excluded property trust where the deceased had an estate interest in possession. In such a case the answer to Question 45 is, "yes". However only limited information needs to be disclosed in form IHT 418. IHT 400 Notes (September 2008) provides:

> **Foreign trusts** If the deceased had a right to benefit from settled property where the assets are overseas and the person who set up the trust was domiciled outside the UK when the trust was created, please answer questions 2 to 5 only.

61.10.2 *Excepted estates*

The IHT (Delivery of Accounts) (Excepted Estates) Regulations 2004 provides different rules for so-called "excepted estates". Regulation 4(1) provides:

> An excepted estate means the estate of a person immediately before his death in the circumstances prescribed by paras (2), (3) or (5).

Thus there are three categories of excepted estate. The first two apply to a person who dies domiciled in the UK.[21] The third applies where:

> (a) the person died on or after 6 April 2004;
> (b) that person was never domiciled in the UK or treated as domiciled in

21 It is doubtful whether a person who is deemed domiciled qualifies under these categories. Reg. 4(5)(b) distinguishes between someone domiciled and someone treated as domiciled in the UK. However, it would be absurd if the estate of a deemed UK domiciliary can never be an excepted estate so it is suggested that the reference to "domiciled in the UK" includes someone deemed domiciled for IHT purposes. But HMRC may disagree. IHT Manual 6020 states that a deemed domiciliary's estate cannot qualify as an excepted estate regardless of the value. The Manual is out of date (as it often is) and is here considering the 2002 Regulations, but the point is the same.

> the UK by section 267 [IHTA];
> (ba) that person was not a person by reason of whose death one of the alternatively secured pension fund provisions[22] applies; and
> (c) the value of that person's estate situated in the UK is wholly attributable to cash[23] or quoted shares or securities passing under his will or intestacy or by survivorship in a beneficial joint tenancy or, in Scotland, by survivorship in a special destination, the gross value of which does not exceed £150,000.[24]

However, while a so-called excepted estate is not required to put in an account *under s.216 IHTA* it is required to deliver more or less the same information set out in reg.6(2):

> The information specified for the purpose of para (1) is—
> (a) the following details in relation to the deceased—
> (i) full name;
> (ii) date of death;
> (iii) marital or civil partnership status;
> (iv) occupation;
> (v) any surviving spouse or civil partner, parent, brother or sister;
> (vi) the number of surviving children, step-children, adopted children or grandchildren;
> (vii) national insurance number, tax district and tax reference;
> (viii) if the deceased was not domiciled in the UK at his date of death, his domicile and address;
> (b) details of all property to which the deceased was beneficially entitled and the value of that property;
> (c) details of any specified transfers, specified exempt transfers and the value of those transfers;
> (d) the liabilities of the estate; and
> (e) any spouse, civil partner or charity transfers and the value of those

22 Reg 4(9) provides:
"In this regulation 'the alternatively secured pension fund provisions' means the following sections of the 1984 Act—
(a) section 151A (person dying with alternatively secured pension fund);
(b) section 151B (relevant dependant with pension fund inherited from member over 75); and
(c) section 151C (dependant dying with other pension fund)."

23 IHT Manual 6018 shows that HMRC sensibly construe "cash" widely, so as to include a bank account.

24 See reg.4(5).

transfers.

It is considered that there is no obligation to give information about excluded property. This is a purposive construction, because, strictly, excluded property is "property to which the deceased was beneficially entitled" even though it does not form part of his estate for IHT purposes immediately before his death. However, it is absurd to say that there is an obligation on excepted estates to disclose excluded property, when there is no such obligation on ordinary estates. In practice the relevant form (IHT 207) does not ask about non-UK property.

61.10.3 *Territorial limitations*

The statutory provisions (as recast in 2004) utterly fail to provide any territorial limitation on the duty to disclose. They merely provide two regimes of disclosure, one for ordinary estates and one for excepted estates. The Courts must devise some territorial limitation, as they have on occasion done elsewhere: *Clark v Oceanic* 56 TC 183. The question is, what should it be? It is suggested that no duty applies to foreign personal representatives of excepted estates. But disclosure in one form or another will be required in all cases where the personal representatives need a UK grant of probate.

61.10.4 *Commentary*

The 2004 Regulations impose a significant burden on (primarily) small estates which would not formerly have had to provide these details. Whether this is a necessary burden is a matter on which views may differ. However, the chutzpah in the explanatory notes still deserves to be recorded:

> 7. **Impact**
> 7.1 These Regulations do not impose new costs on business or charities.

61.10.5 *Conclusion*

Disclosure is required for an excepted estate even though no tax is payable on the death (e.g. because the property falls within the nil rate band). How well observed this requirement is in practice is another matter. However, if a foreign domiciled individual wishes to ensure that his personal representatives are under no duty to put in UK returns on his death, he must not have any UK situate property at the time of his death and should appoint foreign executors. Then there is no duty to disclose the assets of the estate.

61.11 Proceeds of Crime Act 2002 and disclosure of tax avoidance schemes

These topics require books to themselves and are outside the scope of this book.

CHAPTER SIXTY TWO

CATEGORISATION OF FOREIGN ENTITIES

62.1 Categorisation – Introduction

UK tax law categorises entities (in short) as companies, partnerships or trusts.[1] With more or less difficulty (depending on the similarity of the law of the country concerned) it is necessary to shoehorn foreign entities into these categories..

The general approach is explained in *Memec v IRC*:

> When an English tribunal has to apply the provisions of an UK taxing statute to some ... entity which is governed by a foreign system of law, the tribunal must take account of the rules of that foreign system (properly proved if not admitted) in order to determine the nature and characteristics of the ... entity. But having informed itself in this way, the tribunal must then apply the taxing statute as part of English law.[2]

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1 And lastly, PRs but PRs are not relevant to this chapter.

2 71 TC 77 at p.92. This is the usual approach in OECD countries. An OECD Report provides:

> "11. In most [OECD] Member countries, as a matter of principle, tax laws apply on the basis of the legal relationship deriving from other branches of the law. Thus the tax laws of these countries, when referring to partnerships, will, absent special tax definitions, refer to those entities that constitute partnerships according to domestic civil or commercial law.
>
> 12. Difficulties often arise, however, where income is derived by an entity organised under the laws of another jurisdiction. In that case, the entity will have to be classified for purposes of the application of the tax laws of the country where the income is derived, regardless of whether or not that classification is compatible with the civil or commercial law system of the jurisdiction from which the entity derives its legal status.
>
> 13. For example, if the tax system of a country recognises only individuals, companies and partnerships (but not trusts) as taxpayers and provides for a

Subsidiary issues may then arise, for instance whether the rights of the owners of a foreign entity constitute ordinary share capital.

Similar issues may arise in the application of DTTs to foreign (and UK) entities, for instance, whether an entity is a "person" for the purpose of a DTT, and further questions such as treaty-residence may turn largely on matters of categorisation.

62.1.1 *"Transparent" and "opaque"*

UK tax law categorises entities as transparent or opaque.[3] Tax Bulletin 83 explains this terminology:

> Entities are described [in the official list set out below] as either fiscally "transparent" or "opaque" solely for the purposes of deciding how a member is to be taxed on the income they derive from their interest in the entity. In the case of a "transparent" entity the member is regarded as being entitled to a share in the underlying income of the entity as it arises and is charged to tax in the UK on their share of the profits on that basis. But, in the case of an "opaque" entity the member generally is taxed only on the distributions made by the entity.

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different tax treatment for these three types of taxpayers, that country will have to "force" foreign entities in one or the other of these categories (with more or less difficulty depending on the similarity of the civil and commercial law of the countries concerned) for purposes of applying its tax system to domestic income derived by these foreign entities.

14. In doing so, the practice of most countries is to adopt the same approach as the one they apply in a purely domestic context. They will therefore apply their domestic tax classification to foreign entities on the basis of the foreign law's legal characteristics of the entity. In the previous example, the country, for the purposes of taxing the domestic income of a trust established under the law of a foreign jurisdiction, will typically examine the legal characteristics of the trust as they derive from the trust law of the foreign jurisdiction in order to determine whom it should tax and whether that person should be taxed as an individual, company or partnership, which are the only categories recognised under its tax law."

See 62.1.1 ("Transparent" and "opaque").

"Characterisation of Other States' Partnerships for Income Tax", John Avery Jones [2002] BTR 375 is essential reading in this area.

3 A note on terminology. The term sometimes used is "fiscally transparent" but for the purpose of this chapter that is synonymous with "transparent".

The terminology is also used for CGT (e.g. a partnership is transparent for CGT); and for IHT (e.g. a partnership is not transparent for IHT). On the IT transparency of trusts, see 11.15 (Income from IP-type trusts: identifying the source). Tax Bulletin 83 continues:

> It should be noted that the expressions "transparent" and "opaque" are not interchangeable with "partnership" and "company" or "body corporate". For example, a fiscally transparent entity is not necessarily a partnership. Likewise an UK company is a "body corporate" and is opaque for the purposes of UK tax on income, but a fiscally opaque entity is not necessarily a "body corporate" or a "company" for UK tax purposes.

Although the expressions are not interchangeable, the issues overlap, A transparent entity is not necessarily a partnership (it might be an IP trust) but a partnership is necessarily transparent for IT and CGT.[4]

62.1.2 *Categorisation as transparent/opaque*

Tax Bulletin 83 explains HMRC's approach to categorising an entity as transparent or opaque:

> When considering the classification of a foreign entity (i.e. whether it is either opaque or transparent) for UK tax purposes, due regard is given to the approach of the Court of Appeal in the case of *Memec plc v IRC* (71 TC 77) and the line of case law that precedes it. In particular, the following matters should be considered:
> (a) Does the foreign entity have a legal existence separate from that of the persons who have an interest in it?
> (b) Does the entity issue share capital or something else, which serves the same function as share capital?
> (c) Is the business carried on by the entity itself or jointly by the persons who have an interest in it that is separate and distinct from the entity?
> (d) Are the persons who have an interest in the entity entitled to share in its profits as they arise; or does the amount of profits to which they are entitled depend on a decision of the entity or its members,

4 See 28.3 (Transparency of partnership for IT); 28.7 (Transparency of partnership for CGT).

after the period in which the profits have arisen, to make a distribution of its profits.

(e) Who is responsible for debts incurred as a result of the carrying on of the business: the entity or the persons who have an interest in it?

(f) Do the assets used for carrying on the business belong beneficially to the entity or to the persons who have an interest in it?

Some of those factors may point in one direction; others may point in another. An overall conclusion is reached from looking at all the factors together, though some have more significance than others. Particular attention is paid to factors c. and d. In considering them we look at the foreign commercial law under which the entity is formed and at the internal constitution of the entity. How the entity is classified for tax purposes in any other country is not relevant. The conclusion that is reached is then used in considering the relevant piece of UK tax law.[5]

62.1.3 *IHT and IT/CGT settlements*

It was noted above that UK tax law categorises entities as companies, partnership and trusts. However different definitions of trusts are used in different taxes. In this chapter "**IHT-settlement**" means a settlement within the IHT definition and "**IT/CGT settlement**" is a settlement within the standard IT/CGT definition. (The terms trust and settlement are interchangeable.)

Section 43(2) IHTA provides the IHT definition:

"Settlement" means any disposition or dispositions of property, whether effected by instrument, by parol or by operation of law, or partly in one way and partly in another, whereby the property is for the time being—

(a) held in trust for persons in succession or for any person subject to a contingency, or

(b) held by trustees on trust to accumulate the whole or part of any income of the property or with power to make payments out of that income at the discretion of the trustees or some other person, with or without power to accumulate surplus income, or

(c) charged or burdened (otherwise than for full consideration in money or money's worth paid for his own use or benefit to the person making the disposition) with the payment of any annuity or other periodical payment payable for a life or any other limited or

5 This passage is also set out in INT Manual 180010.

terminable period,
[d] or would be so held or charged or burdened if the disposition or dispositions were regulated by the law of any part of the UK;
[e] or whereby, under the law of any other country, the administration of the property is for the time being governed by provisions equivalent in effect to those which would apply if the property were so held, charged or burdened.

The standard IT/CGT definition has (in particular) no equivalent of s.43(2)[d] [e]. I discuss the IT/CGT definition elsewhere[6] and need not set out that definition again. It is a requirement that property is held "in trust". Thus a foreign entity which is not a trust may be an IHT-settlement but not a IT/CGT settlement.

62.1.4 *Meaning of "company"*

Since one question discussed in this chapter is whether foreign entities are "companies" for UK tax purposes, it is necessary to set out the tax definitions of that term. I do so mainly for completeness, as nothing much in this chapter turns on the definition. The position is unnecessarily complicated.

Section 832(1) ICTA provides the definition for the corporation tax acts:

> "company" means, subject to subsection (2) below, any body corporate or unincorporated association but does not include a partnership, a local authority or a local authority association.[7]

6 See 54.2 (Definition of "settlement").

7 Section 832(2) provides five exceptions:

> "The definition of "company" is subject to section 468, and does not apply in the following provisions of this Act, that is to say—
> Chapter I of Part XVII;
> sections 774 to 777;
> section 839;
> para 15 of Schedule 3;
> (and also does not apply where the context otherwise requires because some other definition of "company" applies)."

The exceptions are mostly illogical, though of limited importance. The tax law rewrite rightly deleted the words in brackets (which are otiose) but missed the opportunity to tidy all this up, but there it is.

Section 992(1) ITA provides the same definition for the income tax acts:

> In the Income Tax Acts "company" means any body corporate or unincorporated association, but does not include a partnership, a local authority or a local authority association.[8]

Section 288 TCGA provides a similar definition for the TCGA:

> "company" includes any body corporate or unincorporated association but does not include a partnership, and shall be construed in accordance with section 99;

62.2 Liechtenstein foundation (*Stiftung*)

62.2.1 *Is a foundation an IT/CGT settlement?*

A Liechtenstein foundation normally has legal personality.[9] Biedermann explains:

> Since, in most cases, the Liechtenstein foundation has legal personality, it is subject to the general provisions concerning legal persons and it has a corporate structure with a board of foundation. The *in rem* aspect of the beneficial rights under trusts, i.e. non-reachability of trust property by creditors of the trustee, is not necessary for foundations, since the foundation has its own personality. The beneficial rights under a foundation may be less strong, because there is no specific tracing possibility *vis-à-vis mala fide* purchasers and volunteers. However, this deficiency is overcome by the public faith principle, since anyone dealing with a foundation has to look at the objects and competence

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8 Section 992(2)(3) goes on to provide the same exceptions as in s. 832(2) ICTA:
"(2) Subsection (1) needs to be with read with section 468 of ICTA (authorised unit trusts).
(3) This section does not apply for the purposes of—
(a) Part 6 (venture capital trusts),
(b) Chapters 1, 3 and 4 of Part 13 (transactions in securities and land and sales of income from occupation), and
(c) sections 993 and 994 (meaning of "connected" persons)."

9 See William Easun, "Trusts & Foundations", ITPA Journal Vol 5, No. 3 and "Beneficiaries of Trusts and Foundations" Philip Baker QC, accessible *www.taxbar.com/gitc.html*. In this book I shall not consider foundations which do not have legal personality.

> clause of a foundation in order to know whether a board of foundation is entitled to *e.g.* sell some specific foundation property.[10]

On the evidence of this passage it is considered that property in a foundation is not held "in trust". An essential (or almost essential)[11] characteristic of a trust is that "the assets constitute a separate fund and are not a part of the trustee's own estate".[12] A foundation does not have this characteristic. So it is not an IT/CGT settlement.

A foundation is a settlement-arrangement so it is a "settlement" for the purposes of s.87 TCGA.

62.2.2 *Is a foundation an IHT-settlement?*

Foundation property is normally held "for persons in succession" or "held with power to make payments out of the income". The question is whether a foundation is "equivalent in effect" to a trust. This raises a question of fact as to the effect of a foundation. Lorenz says:

> It now appears that the Liechtenstein Supreme Court has used Liechtenstein trust law as a basis for the development of a coherent pattern of principles applicable to all types of Liechtenstein asset planning devices, in particular foundations and establishments, and not just the trust …
> It is felt … that the internal design of foundations will increasingly come to resemble that of trusts, and that disputes relating to foundations will increasingly be resolved by applying principles of trust law.[13]

Biedermann says:

> Operationally speaking, there is no difference between a family

10 [1993] PCB 283.

11 It is hard to make any comment about trusts without qualification. A charitable trustee incorporated under s.50 Charities Act 1993 would not have a separate fund. But that is a highly anomalous and unusual case and perhaps itself not a "trust" in the ordinary sense.

12 See Article 2 of the Hague Convention on the Law applicable to Trusts and on their Recognition. *Lewin on Trusts* regards this definition as "generally applicable": para 1-01.

13 *Disputes involving Trusts*, edited by Ledim Vogt, published by C H Beck, 1999, p.213.

foundation and a family trust.[14]

On the basis of this evidence it is considered that a foundation is "equivalent in effect" to a trust and is therefore an IHT-settlement. (The contrary argument would have to focus on the word "equivalent", and state that since there are undoubtedly some differences, the two are not equivalent. The expression "equivalent in effect" is looking at the broad substance rather than absolute equivalence but where to draw the line is hard to tell.)[15]

What is more difficult is to determine whether any particular foundation is for IHT a discretionary settlement or interest in possession settlement. At the borderline the distinction between the two is one of form rather than substance, and not appropriate to a foundation which is not even a trust, but merely equivalent in effect. In such cases one can only answer the question on the basis of "doing the best one can" and with the benefit of appropriate foreign law advice. This question does not often matter for IHT for trusts made after 2006.

62.2.3 *HMRC view*

TDSI guidance notes[16] para 2.3 provide:

> **Anstalts & Stiftungs**
> [1] Anstalts and Stiftungs are Liechtenstein business entities which are fiscally opaque. ...
> [2] The current HMRC view is that Stiftungs are Trusts for UK tax purposes. For TDSI purposes, the deposit should be considered to belong to the settlor[17] and the TDSI treatment depends on the nature of the settlor – so if the settlor is an individual, BRT [basic rate of tax] must be deducted.
> [3] If the settlor can show that they have not retained an interest, the Financial Institution can treat the Stiftung as an interest in possession trust ... and the TDSI position will depend on the nature of the

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14 [1993] PCB 283.

15 See also "The Liechtenstein Foundation and UK Tax Avoidance", Robert Venables QC, OTPR Vol.4 p.185.

16 *www.hmrc.gov.uk/tdsi/guidance-notes.pdf*. For TDSI (tax deduction scheme for interest) see 29.7 (Withholding tax on interest from deposit-takers).

17 [Author's footnote] It is assumed that the Stiftung is a settlor-interested trust.

beneficiary. If the beneficiary is an individual, BRT must be deducted.

Point [3] assumes that the stiftung is transparent for IHT which appears to contradict point [1].

The OECD commentary on the Model Treaty records the view that a foundation (*fondation*, *stiftung*) is treated as a body corporate for tax purposes.[18]

62.3 *Anstalt* (Establishment)

TDSI guidance notes[19] para 2.3 provide:

> **Anstalts & Stiftungs**
> Anstalts ... are Liechtenstein business entities which are fiscally opaque. The current HMRC view is that Anstalts should all be dealt with as if they are companies. For TDSI, this means that Anstalts should receive gross interest.

Despite this statement, and classification in the official list as "opaque", HMRC practice has not always been consistent.[20]

62.4 American revocable trusts (grantor trusts)

Revocable trusts are commonly used in the US for estate planning.[21] With an American settlor these are almost always grantor trusts (a US income tax concept) and transparent for US tax purposes as to income and capital gains, though with non-US settlors they are only transparent in limited circumstances.

The classification of a US revocable trust turns on the nature of the rights conferred by the trust, which depends on the drafting and proper law of the

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18 Para 2 of Commentary to OECD Model Convention para 3.

19 *www.hmrc.gov.uk/tdsi/guidance-notes.pdf*. For TDSI (tax deduction scheme for interest) see 29.7 (Withholding tax on interest from deposit-takers).

20 Private correspondence.

21 I am grateful to Ian Watson for his comments on this section. For other US trusts, see Von E. Sanborn, "US tax classification of trusts", (2005) TQR Vol 3 issue 2 p.16 accessible to STEP members on *www.step.org*.

trust.[22] Only general comments are possible here.

Under a common form revocable trust, the settlor (the synonymous terms grantor, trustor, creator or donor are often used in American trust documentation) is sole trustee, the trust is revocable and the income and capital is paid to the settlor on demand. Section 603 of the America Uniform Trust Code[23] provides:

> While a trust is revocable [and the settlor has capacity to revoke the trust],[24] rights of the beneficiaries are subject to the control of, and the duties of the trustee are owed exclusively to, the settlor.

A US revocable trust of this kind is not an IT/CGT settlement as the property is not held "in trust". This seems paradoxical, but the fact that American lawyers describe something as a trust does not mean that it is a trust within the meaning of the word as used in UK statutes. In English law, "there is an irreducible core of obligations owed by the trustees to the beneficiaries and enforceable by them which is fundamental to the concept of a trust. If the beneficiaries have no rights enforceable against the trustees there are no trusts."[25] Any rights which purport to be granted under the US revocable trust during the lifetime of the settlor (or at least while the settlor is mentally competent) are illusory (unassignable and unenforceable).

If the settlor is not the sole trustee, there is a trust, but if (in the words of the Uniform Trust Code) "the duties of the trustee are owed exclusively to the settlor", I would say that the US revocable trust was a bare trust for

22 Each US state is a separate common law jurisdiction, with its own trust law, ultimately derived from English law but with statutory and case law variations.

23 Accessible *www.nccusl.org*. The uniform code project is an attempt to standardise US law. Adoption of uniform codes is far from universal, however, and each state adopting them may do so with variations. Some state statutes (e.g., California Probate Code section 15800) impose rules almost identical in effect to UPC section 603, though independently of the uniform code project.

24 Square brackets in original, as the wording is intended to be optional.

25 *Armitage v Nurse* [1998] Ch at 241 at p. 253. Likewise Hague Convention art.2 ("A trust has the following characteristics ... (c) the trustee has the power and the duty, *in respect of which he is accountable,* to manage, employ or dispose of the assets in accordance with the terms of the trust ..." Lewin on Trusts, 17th ed 1-14 goes slightly further: "the reservation by the settlor of large beneficial powers and interests may leave the lifetime trusts declared in favour of others so squeletic [this non-standard usage is a slip for "skeletal"] as to be considered illusory."

CGT as the settlor is absolutely entitled as against the trustee.[26]

A US revocable trust of this kind is similarly not an IHT-settlement, since:

(1) if the settlor is sole trustee there is no trust;
(2) if the settlor is not sole trustee there is only a bare trust.

The property is not held in trust for persons in succession. The US revocable trust is not even equivalent in effect to a trust for persons in succession. The element of succession is that of a will. In other words, the US revocable trust is in English law a testamentary disposition.[27]

Depending on the wording, the US revocable trust may become a settlement (for IHT and for CGT) if the settlor loses mental capacity. This could of course have significant UK tax consequences.

One could if desired draft a trust which meets the US requirements to be a grantor trust and which is a settlement for IT/CGT and IHT purposes. It would need to be one where the trustees owed duties to beneficiaries other than just the settlor.

62.5 Legal life interest (Northern Ireland)

Legal life interests (Northern Ireland) and proper liferents (Scotland) are a rare in practice, but I discuss them here because (aside from the intrinsic interest of the questions which arise) that sheds some light on the treatment of civil law usufructs.

The CG Manual provides:

> **31303. Northern Ireland**
> The land law of Northern Ireland, except where there is specific legislation to the contrary, is basically the same as the pre-1925 law of England & Wales. Accordingly it is possible to have a legal interest 'limited for life'. Under Section 43(5) IHTA 1984 in such a situation the property is deemed to be settled property.

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26 See s.60 TCGA 1992.

27 The grantor trust may then be void in English law, lacking the formalities required for a valid will; but it may be saved by the Wills Act 1963. If the trust is void in English law but valid in US law, appropriate conflicts principles must be applied to see which legal system has priority. Underhill & Hayton agree: *Law Relating to Trusts & Trustees*, 17th ed 2006, para 4.8 fn1.

This is correct. Section 43(5) IHTA provides:

> In the application of this Act to Northern Ireland this section shall have effect as if references to property held in trust for persons included references to property standing limited to persons...

The Manual continues:

> There was no comparable provision for CGT until Section 63A TCGA 1992 was enacted in FA 2006 with effect from 6 April 2006. Under this provision where a person with a legal interest limited for life dies, a person who acquires in fee simple or fee tail in possession as a consequence of the former person's death is deemed to acquire all the assets forming part of the property at market value at death. This does not apply to land in Ireland outside Northern Ireland.

Section 63A TCGA provides:

> (1) The provisions of this Act, so far as relating to the consequences of the death of a person to whom property in Northern Ireland stands limited for life ("the deceased"), shall have effect subject to the provisions of this section.
> (2) A person who acquires property in fee simple absolute or fee tail in possession as a consequence of the deceased's death shall be deemed to have acquired all the assets forming part of the property at the date of the deceased's death for a consideration equal to their market value at that date.

This confers a tax free uplift on death[28] but does not make the legal life interest into a settlement for IT/CGT purposes. Thus if the life tenant and the remainderman sell their interests:

(1) the relief in s.76 TCGA does not apply.
(2) the life tenant may qualify for MPR relief but the remainderman will not qualify (unless he occupies the property as his MPR, which would not be usual.) The relief in s.225 TCGA will not apply.

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28 This applies even if the life interest is not an estate IP: the drafter of the 2006 reforms overlooked Northern Ireland life interests.

In practice, if MPR relief applies, it is better to create a classic settlement and not a legal life interest because then the property can be sold during the lifetime of the life tenant free of CGT.

62.6 Proper liferent (Scotland)

The CG Manual helpfully explains the Scots law background:

> **31301. Scottish proper liferents** [August 2007]
> In Scotland the expression 'liferent' is used to describe the situation where the income from particular property is to be paid to a person, the liferenter, for a specified period, generally his or her lifetime. At the end of the period the property will generally pass to a person known as the fiar.
> There are two ways in which a liferent can be set up. In the first case, where the interest is known as an improper liferent, the property is vested in trustees who administer the property and pay the income to the liferenter. In general the trustees have the power to sell the property in question and replace it by other property, whether land and buildings or other assets. On the death of the liferenter the provisions of s.72, s.73 and s.74 TCGA apply as appropriate. See CG36450+.

An improper liferent appears to be a classic settlement, and its tax treatment is straightforward. We are concerned with proper liferents. The Manual continues:

> In the second case, the title to heritable property (land and/or buildings) is held by the liferenter. In this situation he or she is a proper liferenter. A proper liferenter cannot dispose of a greater title than his own. He cannot dispose of the property in his will. On his death the property passes to the fiar.
> Where property in Scotland passes to a person for life under a will, and there is no suggestion that it is to be held by trustees, he has a proper liferent.

The Manual goes on to consider the CGT treatment:

> A proper liferent does not make the relevant property settled property [for CGT]. Section 43(4)(c) IHTA 1984 provides that it is settled property for IHT purposes. TCGA does not go so far, but Section 63 provides that the person entitled to possession on the death of a proper

> liferenter shall be deemed to have acquired all the assets forming part of the property at their market value at death.

Section 63 TCGA provides:

> (1) The provisions of this Act, so far as relating to the consequences of the death of a proper liferenter of any property, shall have effect subject to the provisions of this section.
> (2) On the death of any such liferenter the person (if any) who, on the death of the liferenter, becomes entitled to possession of the property as heir shall be deemed to have acquired all the assets forming part of the property at the date of the deceased's death for a consideration equal to their market value at that date.

The Manual concludes:

> The disposal or termination of a proper liferent may qualify for private residence relief under section 222 TCGA as it is an interest in land.

As in Northern Ireland, this confers a tax free uplift on death[29] but it does not make the proper liferent a settlement for CGT purposes. Thus if the liferenter and the remainderman sell their interests:

(1) The relief in s. 76 TCGA 1992 does not apply.
(2) The liferenter may qualify for MPR relief but the remainderman will not qualify (unless he occupies the property as his MPR, which would not be usual). The relief in s. 225 TCGA will not apply.

In practice, if MPR relief applies, it is better to create a classic settlement and not a proper liferent, because then the property can be sold during the lifetime of the liferenter free of CGT.

The IHT Manual provides:

> **16071. Introduction** [June 2007]
> The original view was that a proper liferenter was beneficially entitled to the property which was the subject of the liferent and that a proper liferent was a "settlement" within the meaning of [s. 43 IHTA 1984]

29 This applies even if the liferent is not an estate IP: the drafter of the 2006 reforms overlooked Scottish liferents.

with the result that the liferenter fell to be treated as beneficially entitled to the settled property.

However the Board were advised that a proper liferenter was beneficially entitled only to his right to the liferent and not to the property itself so that on the death of a proper liferenter the liferenter was beneficially entitled to the liferent and not to the capital in which it subsisted. It follows that on the death of the liferenter the value to be placed on the proper liferent was nil.

16072. IHT position [June 2007]

The Section 93 FA 1980 brought proper liferents into line with the settled property regime of the [IHTA] ... [The Manual then summarises the legislative provisions referred to below].

Section 43(4) IHTA provides:

In relation to Scotland "settlement" also includes...

(c) any deed creating or reserving a proper liferent of any property whether heritable or moveable (the property from time to time subject to the proper liferent being treated as the property comprised in the settlement);

and for the purposes of this subsection "deed" includes any disposition, arrangement, contract, resolution, instrument or writing.

Sections 46, 47 IHTA provide:

46 Interest in possession: Scotland

In the application of this Act to Scotland,

[1] [a] any reference to an interest in possession in settled property is a reference to an interest of any kind under a settlement by virtue of which

[i] the person in right of that interest is entitled to the enjoyment of the property or

[ii] would be so entitled if the property were capable of enjoyment,

[b] including an interest of an assignee under an assignation of an interest of any kind (other than a reversionary interest) in property subject to a proper liferent;

[2] and the person in right of such an interest at any time shall be deemed to be entitled to a corresponding interest in the whole or any part of the property comprised in the settlement.

47 Reversionary interest

In this Act "reversionary interest" means

[a] a future interest under a settlement, whether it is vested or contingent (including an interest expectant on the termination of an interest in possession which, by virtue of section 50 below, is treated as subsisting in part of any property) and

[b] in relation to Scotland includes an interest in the fee of property subject to a proper liferent.

Lastly, for completeness, s. 142(7) IHTA provides that for the purposes of s. 142 IHTA (deeds of variation):

> In the application of subsection (4) above to Scotland, property which is subject to a proper liferent shall be deemed to be held in trust for the liferenter.

62.7 Usufructs

62.7.1 *The property law background*

A discussion of the law(s) of usufructs[30] is not possible here. In outline, Article 578 of the French Code Civile provides:

> An usufruct is the right to enjoy property belonging to another, as if its owner, at the expense of preserving that property.[31]

The owner of the right is called "**the usufructuary**" and the owner of the property subject to the right is here called "**the encumbered owner.**" (I think this is a clearer term than "bare owner" which would be a more literal translation of the French term *nu-propriétaire*.)

62.7.2 *Capital Gains Tax*

The CG Manual para 31305 [August 2007] provides:

30 I do not distinguish here between usufructs under different civil law jurisdictions, though it is possible that there are material differences; I would be grateful for the comments of any reader with expertise in these areas.

31 *L'usufruit est le droit de jouir des choses dont un autre a la propriété, comme le propriétaire lui-même, mais à la charge d'en conserver la substance.* The Code Civile is accessible in French on *www.legifrance.gouv.fr*.

> A usufruct governed by French law would be regarded as a non-trust arrangement as it is broadly similar to a Scottish proper liferent.

This is clearly right. Thus if the usufructuary and the encumbered owner sell their interests:

(1) The relief in s.76 TCGA does not apply.
(2) The life tenant or may qualify for MPR relief but the encumbered owner will not qualify (unless he occupies the property, which would be unusual.) The relief in s.225 TCGA will not apply.

There is no CGT uplift on the death of the usufructuary.

It is not possible to avoid this problem by creating a classic settlement instead of a usufruct, because civil law systems do not usually recognise trusts; even if a trust is theoretically possible, it is probably not practical for tax reasons or because it raises too many uncertainties.

The result is a CGT discrimination against usufructs. If the usufruct is in an EU jurisdiction, this discrimination is very difficult to justify, and it is suggested that an uplift on death should be available under European law principles, and, arguably, MPR relief on a sale during the lifetime of the usufructuary.

62.7.3 *Inheritance Tax*

Is a usufruct governed by foreign law equivalent in effect to a classic life interest settlement, and so a settlement within the IHT definition? There is an element of succession, but there are major differences, and it is tentatively suggested that a usufruct is more like a lease for life than a classic settlement, so it is not an IHT-settlement.[32]

If a usufruct is a settlement, there could be charges to IHT on the creation of the usufruct, on ten-year anniversaries[33] and on the death of the life tenant, though the property will often qualify as excluded property (depending of course on the domicile of the settlor and, if a spouse, the domicile of the usufructuary). DTT relief will occasionally be available.

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32 This issue does not arise for proper liferents (Scotland) or legal life interests (Northern Ireland) since the last paragraph of the definition dealing with provisions "equivalent in effect" only applies to non-UK legal systems.

33 Though a usufruct created on death will qualify as an IPDI.

On the other hand, if the usufruct is a settlement, the interest of the encumbered owner is a reversionary interest and so in principle excluded property, which is helpful to the taxpayer if the encumbered owner is UK domiciled. So depending on the circumstances it will sometimes be in the taxpayers interest to argue the issue one way and sometimes the other; and the same applies for HMRC.

In practice I expect that (if the issue is considered at all) a taxpayer takes whichever view suits him better, and in this toss-a-coin area, and in the absence of HMRC guidance, HMRC may adopt whichever view suits them better, whichever view leads to a just result, or whichever view the taxpayer adopts.

62.8 Société civile and Société en nom collectif

The ITH provides:

> **304. Company and partnership distinguished**
> A company, therefore, acts for itself and not as agent or representative of its members. When profits arise they arise to the company and not to the shareholders. The shareholders have no right to them as profit. The rights of the shareholders include the right to a dividend when formally declared. In a partnership, on the other hand, each partner is the agent of the other partners. The profits arise to each partner according to the provisions of the partnership agreement. It is the existence of that agency relationship which distinguishes a partnership from a company. It is broadly true to say that a partnership does not have, as a company does, distinct legal persona but the presence of legal persona is not in itself conclusive. In Scotland a partnership is a distinct legal entity but there is, at the same time, an agency relationship between the firm and its members and between its members. That agency relationship is the hallmark of partnership and characterises the Scots partnership as a partnership rather than as a company. Considerations of this sort are important when dealing with some unfamiliar European company cum partnership creations. The French Société Civile is one such body and the Société en nom Collectif is another. Broadly speaking we regard the first as a company the second as a partnership. Both have legal personality but in the former case the profits arise to the body itself and in the latter case we take the view that the profits arise to the partners. There is more about how we decide which category is appropriate in chapter 16 (ITH1672–ITH1675). ...

> **1673. Establish facts**
> The first stage is one of factual enquiry and in relation to any appeal procedure is a matter for the Appeal Commissioners. It can be a difficult stage – even for trained Revenue lawyers. Experts have been known to differ and in a case about these bodies *Dreyfus v IRC* 14 TC 560 we think the Commissioners came to a wrong decision and we do not follow the Courts ruling. The case involved a French SNC and the Courts said it was a company, being guided by the Commissioners' finding of fact about foreign law. We – after listening to expert advice – think it analogous to a partnership. This question of foreign law is difficult. Where the foreign law is a common law it will often share basic concepts with English law and that eases things a little. But if the foreign law is a civil law – a written code of law – the chances of a communications gap developing between a foreign expert adviser and an English lawyer seeking his advice are much greater.
> There are no hard and fast rules governing this question of foreign law; every association has to be considered separately and in the light of its Articles of Association or equivalent code. We look for indicators as to whether the Association carries on the business itself or whether the participators do so jointly; and whether the profits accrue directly to the participators or whether they accrue to the Association which then distributes them to the participators. These conclusions should then help us decide whether the members of the Association are carrying on a trade, profession or vocation solely or in partnerships and, if so, whether the income is immediately derived by the member from the carrying on of that trade.

But a société civile is classified as a partnership in the UK/France IHT DTT.[34]

62.9 Jersey partnerships

HMRC classify a Jersey LLP as opaque in the official list. This is controversial.[35]

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34 See 50.5.2 (Treaty situs rules: France and Italy). See too "Characterisation of Other States' Partnerships for Income Tax", John Avery Jones [2002] BTR at p.425.

35 See "Limited liability Partnerships: True Partnerships" Jonathan Walker [1998] JLR 1. In *R v IRC ex p. Bishopp* 72 TC 322 the Court was asked but refused to express a view. On the transparency of partnerships generally, see 28.3 (Transparency of partnership for IT) and 28.3 (Transparency of partnership for CGT).

A Jersey simple partnership is transparent: *Padmore v IRC* 62 TC 352. It is considered that a Jersey limited partnership is transparent. (It is similar to a Guernsey limited partnership which HMRC classify as transparent in the official list.)

62.10 Hindu undivided property

The CG Manual para 31305 [August 2007] provides:

> a case involving Hindu Undivided Property would be regarded as a discretionary trust rather than an unincorporated association.

I would be grateful to any reader who could comment on the correctness of this view.

62.11 Japanese tokkin

HMRC regard a tokkin as transparent. The INTM provides:

> **355160. Claims by Japanese "Tokkin" funds** [July 2005]
> 'Tokkin' is an abbreviation of 'tokutei kinsen', and means 'designated monetary trust'.
> Cash or other assets for this type of fund are deposited by the investor(s) with a trustee who manages them on behalf of the investor(s), and in accordance with his/her/their instructions. The tokkin is set up and managed under the terms of a written agreement between the parties, drawn up under Law No 62 of 21/4/1922 of Japan.
> Because the Dividends and Interest Articles of the convention provide for relief **only to the beneficial owner** (INTM332000) of the income, claims in respect of income paid to tokkin funds **must** be made by the beneficial owner of the tokkin (the 'investor(s)'above), and **cannot** validly be made by the tokkin's manager.
> So if you see a claim or supporting voucher which makes any reference to tokkin, you should ensure that you consider only claims made by the beneficial owner, that is, the **original investor**, in respect of his/her/their share in the tokkin.
> There is no reason why a single investor should not own **all** the funds in a tokkin, but you should make certain that your claim has been made by the beneficial owner and not by the trustee, or an investment manager.

> The original investors/beneficial owners may be either individuals or companies.
> But it should be clear in either case that **no** relief can be due to the tokkin **itself**.

62.11.1 Dutch bewind

Kortmann and Verhagen say:

> The *bewind* cannot be characterised as a trust in the sense of Article 1 of the Principles. A trust in the sense of the Principles only exists in situations where the trustee legally owns the assets to be managed, which is not so in the case of *bewind*. In the case of *bewind* the beneficiary is legal owner of the assets to be managed. There are, however, restrictions on the beneficiary's right to dispose of the assets placed under *bewind*. Either the legal owner cannot dispose of these assets at all, or he can only do so subject to the *bewind*. The *bewindvoerder*, as the administrator is usually called, acts in the case of *bewind* only as agent for the owner of the assets (the beneficiary). Because the assets to be managed are not legally owned by the *bewindvoerder*, the assets remain unaffected by the bankruptcy of the *bewindvoerder*.[36]

On this basis it is considered that a bewind is transparent for CGT, IT and IHT. It is not a trust for CGT, not an IHT-settlement and not a settlement for s.87 TCGA.

62.12 US limited liability companies

Tax Bulletin 29 (June 1997) provides:

> **UK/US DT convention: US limited liability companies (LLCs)**
> Generally speaking, United States federal income tax is charged on the profits of LLCs on the basis that they are fiscally transparent, ie tax is imposed on the members of the LLC and not on the LLC itself.
> However, for the purposes of UK tax we have taken the view in relation to those LLCs that we have so far considered that they should be

36 *Principles of European Trust Law, Law of Business and Finance* Vol 1, Hayton, Kortmann and Verhagen, p.199.

> regarded as taxable entities and not as fiscally transparent. Accordingly we tax a UK member of a LLC by reference to distributions of profits made by the LLC and not by reference to the income of the LLC as it arises.

An institution which is categorised as transparent in one jurisdiction but not in another is known as "hybrid."

The bulletin followed with a concession but the problem is now dealt with in the 2001 treaty, see 41.17 (USA DTT). Also see 62.15.3 (Ordinary share capital: Delaware LLC).

62.13 HMRC official list of transparent and opaque entities

Tax Bulletin 83 explains the HMRC view:

> **Foreign Entities: Classifications for UK Tax Purposes**
> ...
> A list of foreign entities where we have been asked our view on the question of transparency/opacity is set out below. ...

I refer to this as "**the HMRC official list**".

> It should be noted that the list only gives our general view as to the treatment of the specified foreign entity. In a particular case regard may also need to be had to:
> - The specific terms of the UK taxation provision under which the matter requires to be considered:
> - The provisions of any legislation, articles of association, by-laws, agreement or other document governing the entity's creation, continued existence and management, and;
> - The terms of any relevant Double Taxation Agreement.
>
> It should also be borne in mind that in relation to the classifications set out on the list:
> - In some instances HMRCs view was given many years ago, and there may have been significant changes in the relevant foreign law which may mean that a different conclusion as to the status of that entity might now be reached. Changes in foreign law after the publication of this article may be significant for the same reason. ...
>
> Where clarification is sought in relation to a foreign entity we will attempt to give a view in particular cases in line with Code of Practice

10.[37]

An OECD Report[38] sets out a helpful list of entities of OECD countries giving their main tax treaty characteristics. I here set out a combination of three lists: the TB 83 list in full, together with the additional references in the version of that list in INT Manual 180030 [October 2007].[39] I add the English translation from the OECD list, and the reader who needs more information about an entity in an OECD country should turn to the OECD report.

List of Foreign Entities **Country and name of entity**	**UK tax treatment & date last considered**	**OECD Translation**
ANGUILLA		
Partnership	Transparent 10/1991	
ARGENTINA		
Sociedad de responsabilidad[40] limitada	Opaque 6/1958	
ARMENIA		
Limited Liability Company (LLC)	Opaque 5/06	
AUSTRIA		
Kommanditgesellschaft (KG)	Transparent 8/1971	Limited Partnership
Kommandit[41] Erwerbsgesellschaft (KEG)	Transparent 11/2003	Limited Partnership
GmbH & Co KG	Transparent 5/2002	
Gesellschaft mit Beschränkter Haftung (GmbH)	Opaque 11/2005	Limited liability company
Aktiengesellschaft (AG)	Opaque 11/2005	Company
BELGIUM		
Société privée à responsabilité limitée (SPRL)	Opaque 8/1994	Limited liability partnership
Société en nom collectif (SNC)	Transparent 5/1992	General partnership
Société Anonyme (SA)	Opaque 11/2005	Limited company
Naamloze Vennootschap (NV)	Opaque 11/2005	Limited company
Société en commandite[42] par actions (SCA)	Opaque 11/2005	Company limited by shares

37 This passage is also set out in INT Manual 180010.

38 "The Application of the OECD Model Tax Convention to Partnerships" (OECD, 1999) accessible (at a small charge) from *www.oecd.org*.

39 I have restored diacritical marks which HMRC somewhat illiterately omitted in the official list. I would be interested to hear from readers with expert knowledge of the entities listed here if they consider the HMRC view to be erroneous.

40 HMRC original erroneously reads: responsibilidad.

41 HMRC original erroneously reads: Kommand.

42 HMRC original erroneously reads: commanditaire.

Commanditaire vennootschap[43] op aandelen (CVA)	Opaque 11/2005	Company limited by shares
BRAZIL		
Sociedade por quotas de responsabilidade[44] limitada (Srl)	Opaque 1/1977	
CANADA		
Partnership and limited partnership	Transparent 11/2005	
CAYMAN ISLANDS		
Limited partnership	Transparent 11/1993	
CHILE		
Sociedad de responsabilidad[45] limitada (SRL)	Transparent 9/2003	
CHINA		
Wholly foreign owned entity (WFOE)	Opaque 10/2005	
CZECH REPUBLIC		
Akciová společnost (as)	Opaque 11/2005	Joint-stock company
Společnost s ručením omezeným (sro)	Opaque 11/2005	Limited liability company
EUROPEAN UNION		
Societas Europeas (SE)	Opaque 7/2005	
FINLAND		
Kommandiittiyhtiö (Ky)	Transparent 5/1991	Limited partnership
Osakeyhtiö (Oy)	Opaque 11/2005	Limited company
Aktiebolag (Ab)	Opaque11/2005	Limited company
FRANCE		
Groupement d'intérêt économique (GIE)	Transparent 5/1988	Economic interest grouping
Société en nom collectif (SNC)	Transparent[46] 8/2000	General partnership
Société civile immobilière (SCI)	Opaque 11/2005	
Société civile agricole (SCA)	Opaque 2/1998	
Société en commandite simple (SCS)	Transparent 9/1997	Limited partnership
Société en participation (SP)	Transparent 6/1992	Undeclared partnership
Société à responsabilité limitée (SARL)	Opaque	Limited liability company
Fonds Commun de Placement à risques (FCPR)	Transparent 1/1997	
Société par Actions Simplifiée (SAS)	Opaque 4/2004	
Société anonyme (SA)	Opaque 4/2004	Company limited by shares
Groupement Foncier d'Agricole (GFA)[47]	Opaque 5/2001	

43 HMRC original erroneously reads: venootschap.

44 HMRC original erroneously reads: responabilidade.

45 HMRC original erroneously reads: responsibilidad.

46 See 62.8 (Société Civile and Société en nom collectif).

47 This is a misprint but I do not know what is intended.

Société Civile (SC)	Opaque[48] 11/2005	Civil partnership
GERMANY		
Stille Gesellschaft	Opaque 6/1998	Silent partnership
Kommanditgesellschaft (KG)	Transparent 2/1997	Limited partnership
Offene Handelsgesellschaft (OHG)	Transparent 9/1996	General partnership
Gesellschaft mit beschränkter Haftung (GmbH)[49]	Opaque 2/1997	Limited liability company
GmbH & Co. KG	Transparent 2/1997	
Gesellschaft des bürgerlichen Rechts (GbR)	Opaque 4/1994	Civil law partnership
Aktiengesellschaft (AG)	Opaque 11/2005	Limited liability company
GUERNSEY		
Limited Partnership (LP)	Transparent 1/2005	
Protected Cell Company (PCC)	Opaque 11/2004	
Open Ended Investment Company with Limited Liability	Opaque 11/2004	
HUNGARY		
Korlátolt felelösségü társaság (Kft)	Opaque 11/2005	Limited liability company
Részvénytársaság (Rt)	Opaque 11/2005	Company limited by shares
ICELAND		
Hlutafélag	Opaque 11/2005	Public limited liability company
IRELAND		
Limited Partnership	Transparent	
Irish Investment Limited Partnership	Transparent	
Common Contractual Fund (CCF)	Transparent 1/2004	
ITALY		
Societa per Azioni (SpA)	Opaque 11/2005	
JAPAN		
Goshi-Kaisha[50]	Transparent 2/1997	
Gomei Kaisha	Transparent	
Tokumei Kumiai (TK)	Transparent 11/2005	
Kabushikikaisha	Opaque 11/2005	Joint stock company
Yugen-kaisha	Opaque 11/2005	Limited liability company
JERSEY		
Limited Liability Partnership (LLP)[51]	Opaque 2/2001	
KAZAKHSTAN		
Limited Liability Company (LLC)	Opaque 9/2005	
LIECHTENSTEIN		

48 See 62.8 (Société Civile and Société en nom Collectif).
49 See 62.15.4 (Ordinary share capital: German GmbH).
50 HMRC original erroneously reads: Goshi-Kaisa
51 See 62.9 (Jersey partnerships).

Anstalt[52]	Opaque 3/2004	
LUXEMBOURG		
Société en commandite par actions (SCA)	Opaque 7/1992	Limited partnership with share capital
Fonds commun de placement (FCP)	Transparent 5/2005	
Société anonyme (SA)	Opaque 11/2005	Company limited by shares
Société à responsabilité limitée (SARL)	Opaque 11/2005	Limited liability company
Société d'investment à capital variable[53] (SICAV)	Opaque 3/2006	
Société en nom collectif (SNC)	Transparent 2/2007	
NETHERLANDS		
Vennootschap Onder Firma (VOF)	Transparent 2/1995	General partnership
Commanditaire Vennootschap both "open" and "closed" (CV)	Transparent 8/2000	Limited partnership
Naamloze Vennootschap (NV)	Opaque 10/1981	Joint stock company
Besloten Vennootschap Met Beperkte Aansprakelijkheid[54] (BV)	Opaque 10/1981	Limited liability company
Maatschap	Transparent 10/1993	Partnership
Stichting	Transparent 7/2005	
Cooperatie (Co-op)	Transparent 7/2004	
NEW CALEDONIA		
Société en nom collectif (SNC)	Transparent 7/2005	
NORWAY		
Aksjeselskap[55] (AS)	Opaque	Limited liability company
Kommandittselskap[56] (KS)	Transparent 1/1981	Limited partnership
POLAND		
Spólka z ograniczona odpowiedzialnoscia[57] (SP. zo. o)	Opaque 3/1996	
PORTUGAL		
Sociedade por quotas (Lda)	Opaque 4/1993	
Sociedade Anónima (SA)	Opaque 4/1993	
RUSSIA		
Joint Venture under "Decree No. 49"	Opaque 1/1993	
Limited Liability Company (LLC)	Opaque 11/2003	
SLOVAK REPUBLIC		
Spoločnost's ručenim obmedzením (sro)	Opaque 11/2005	Limited liability company
SPAIN		

52 See 62.3 (Anstalt (Establishment)).
53 HMRC original erroneously reads: Société d'investment à capitale variable.
54 HMRC original erroneously reads: Aansprakelijheid.
55 HMRC original erroneously reads: Alkjeselskap.
56 HMRC original erroneously reads: Kommandittselkap.
57 HMRC original erroneously reads: Spolkaz ograniczonaodpowiedzialnoscia.

Sociedad Civil[58] (SC)	Opaque 12/1980	Civil law partnership
Sociedad Anónima (SA)	Opaque 11/2005	Company limited by shares
Comunidad de bienes	Transparent 6/2001	
Sociedad de Responsabilidad Limitada (Srl)	Opaque 11/2005	
SOUTH AFRICA		
Close Corporation	Opaque 11/2005	
SWEDEN		
Aktiebolag (AB)	Opaque 11/2005	Limited company
Kommanditbolag (KB)	Transparent 10/2005	Limited partnership
SWITZERLAND		
Société Simple (SS)	Transparent 12/1990	
Gesellschaft mit beschränkter Haftung (GmbH)	Opaque 11/2005	Limited liability company
TURKEY		
Attorney Partnership (AP)	Transparent 4/2004	
Anonim Şirket (AŞ)	Opaque 11/2005	Joint stock company
Limited Şirket (Ltd Ş)	Opaque 11/2005	Limited liability company
USA		
Partnership set up under the Uniform Partnership Act	Transparent 9/1983	
Limited Partnership set up under the Uniform Limited Partnership Act	Transparent 8/2000	
Limited Liability Company (LLC)[59]	Opaque 6/1997	
Limited Liability Partnership (LLP)	Transparent 12/1999	
Massachusetts Business Trust (MBT)	Transparent 2/1980	
S. Corporation (S. Corp)	Opaque 7/2005	
Real Estate Investment Trust (REIT)	Opaque 11/05	

62.14 Stamp Taxes Manual body corporate list

The Stamp Taxes Manual offers another list (with some overlap) addressing the question of whether a foreign entity is a body corporate:

> **6.124** Some foreign companies have been accepted as falling within the term 'body corporate' for the purposes of the intra group relief. The following is a list of examples of foreign bodies accepted by us as falling within the definition of "body corporate" for Section 42 [FA 1930] and Section 151 [FA 1995] purposes:–

58 HMRC original erroneously reads: Civila.

59 See 62.12 (US limited liability companies).

Although the list is expressed to be for the purposes of two specific provisions, there is no special definition of "body corporate" in those sections; if an entity is an entity for those purposes, it is a body corporate (and so a company) for tax purposes generally.

Australia	Private companies which do not need to comply with certain requirements, are known as 'proprietary' companies. Such companies registered in New South Wales are bodies corporate.
Bahamas	Companies described as limited.
Belgium	Société de personnes à responsabilité limitée (descussocies).[60]
Bermuda	Companies described as limited.
British Virgin Islands	A company described as limited and which is incorporated under the Companies Act 243.
Canada	Companies described as limited. (Ltd)
Cayman Islands	Companies described as Ltd.
Denmark	A company described as an A/S.
Finland	An 'Oy' (Osakeyhtiö) is a Finnish limited company which may be public or private.
France	Société Anonyme (SA) and Société en commandite par actions.
Germany	Aktiengesellschaft. (AG) Gesellschaft mit Beschränkte Haftung. (GmbH) Kommanditgesellschaft[61] auf Aktien. (KGaA)
Guernsey	A company constituted under the laws of Guernsey and Registered before the Royal Court.
Holland	Naamloze Vennootschap. (NV) Besloten Vennootschap. (BV)
Hong Kong	Companies described as limited.
Irish Minister of State	An Irish minister may be accepted as a parent body corporate for S42 purposes
Italy	Societa per Azioni. (SPA)
Liberia	Companies described as limited but note that we may require to see the Certificate of Incorporation.
Malaysia	A company which includes the word 'Berhad' as part of and at the end of its name.
Netherlands Antilles	Naamloze Vennootschap or NV.
Norway	Aksjeselskap (et) or Aktieselskap[62] (et). (AS)
Panama	Sociedad Anonima. (SA) 'Corp.' 'Inc.' Note that 'Ltd' is not conclusive.
Portugal	A body which is a Sociedade por Quotas.
Saudi Arabia	A company organised pursuant to the laws of the Kingdom of Saudi Arabia has been accepted although it did not have perpetual succession.

60 "descussocies" is a misprint but I do not know what is intended.

61 HMRC original erroneously reads: Kommanditfellschaft.

62 HMRC original erroneously reads: Aktieselscap.

Singapore	Companies described as limited.
South Africa	A Company which is 'limited by shares'.
Spain	Sociedad Anonima (SA) and Sociedad de Responsabilidad Limitada. (SRL)
Sweden	Aktiebolaget (AB) Also The Kingdom of Sweden.
Switzerland	Société Anonyme (SA), Société en commandite[63] par actions and Aktiengesellschaft (AG). A verein.[64]
Trinidad	A company limited 'by shares'.
USA	Corporations (usually described as 'Corporation' 'Company' or 'Incorporated') organised under the laws of various states. Delaware Limited Liability Companies.
Venezuela	Corporations organised under the laws of Venezuela.

62.15 Share capital

62.15.1 *Significance of ordinary share capital*

If an entity issues ordinary share capital, it may be a "75% subsidiary" for the purposes of s.838(1)(b) ICTA 1988. It follows that it is possible for the entity to qualify for CGT and IT group reliefs, and to benefit from CGT reliefs for share exchanges.

62.15.2 *When does a body have ordinary share capital?*

HMRC Brief 54/07 provides:

> **Meaning of Ordinary Share Capital**
> HMRC has been asked to provide a list of foreign entities that it considers to have 'Ordinary Share Capital' for the purposes of Section 832 ICTA 88. Unfortunately as each case will have its own particular set of facts it is not feasible for an exhaustive list to be created, nor, in the context of considering legal systems other than the UK's, that are subject to change, would it be practical to do so.
> Set out below is HMRC's interpretation of Section 832 ICTA 88 and information that, it is hoped, will be useful to companies and advisors, as well as officers within HMRC, in deciding whether a particular non-UK entity has 'Ordinary Share Capital' for the purposes of section 832 ICTA 88. Also included below are some details of our position on two of the most often queried foreign entities, the Delaware LLC and the German GmbH.
> Please note, this brief only seeks to consider the meaning of 'Ordinary Share

63 HMRC original erroneously reads: commandit.
64 "A verein" is a misprint but I do not know what is intended.

Capital' for the purposes of section 832 ICTA 88. Specifically, it does not cover the classification of a foreign entity for UK tax purposes (whether it is "transparent" or "opaque"). Information on that topic is contained in Tax Bulletin 83 published in June 2006.

The reader should also note that the Companies Act 2006 received Royal Assent on 8 November 2006 and the Government has announced its intention to commence all parts of the act by 31 October 2008. The DBERR has published an implementation timetable according to which the relevant sections of Part 17, A Company's Share Capital, will come into force on 1 October 2008. This article will be reviewed in due course to ensure it takes account of any necessary amendments due to legislative changes.

Definition

Ordinary share capital is defined in Section 832 ICTA 88 as follows:

> "ordinary share capital", in relation to a company, means all the issued share capital (by whatever name called) of the company, other than capital the holders of which have a right to a dividend at a fixed rate but have no other right to share in the profits of the company;

This definition therefore includes all of the issued share capital of a company, apart from capital carrying a right to a dividend at a fixed rate only. The bracketed wording "by whatever name called" should not be overlooked as it is important to note that companies often categorise share capital into shares bearing different names, eg A Ordinary; B Ordinary, for purposes which may be of no relevance to the application of the definition above.

Characteristics of issued share capital in a UK company – general principles.

UK Companies

Ordinarily, references to a company will be understood to mean a limited liability company. Limited liability companies are so called because the liability of each shareholder for the company's debts and other liabilities is limited to the amount which remains unpaid on his shares. There are two types of limited liability company in the UK, public and private. The main difference between these types of company is that a public company can apply to be listed and offer its shares to the public in order to raise capital.

There are, however, other types of less commonly used company forms: unlimited companies, with or without share capital, and companies limited by guarantee.

In the latter case the members' liability is limited to amounts they undertake to contribute in the event of a winding up; the amount of this maximum liability of each of the members will be set out in the "guarantee clause" of the company's memorandum. The total commitment of the members, taken together, is known as the "guarantee fund"; this fund only comes into existence on a winding up. In practice, this form of vehicle is usually unsuitable for most businesses but is often used, for example, by charities.

Companies limited by guarantee incorporated on or after 22 December 1980 cannot also have a share capital (Section 1(4) Companies Act 1985). Companies limited by guarantee incorporated before that date may, however, also have share capital.

In 1999 the Special Commissioners considered the status of 'founders' deposits' with a company limited by guarantee in the case *South Shore Mutual Insurance Co Ltd v Blair* 1999 STC (SCD) 296. They came to the conclusion that the deposits were not issued share capital; the company did not, in fact, have any authorised share capital and, as a consequence, could not have issued share capital. Although the decision is not binding authority, the case contains a useful review of some of the authorities about share capital.

Shares in UK Companies

A company limited by shares is currently required to stipulate the maximum share capital the company may issue and the number and nominal value of the shares into which it is divided, its “authorised share capital”, in a document called the company’s memorandum of association (section 2(5)(a), Companies Act 1985).

The memorandum is one of two essential documents that must be filed at Companies House on incorporation, the second is the company’s articles of association; these documents together set out provisions governing the manner in which the company will operate. The amount of authorised share capital set out in the company’s memorandum may be later increased by an ordinary resolution of the shareholders (requiring a simple majority of the vote).

The company’s assets are owned by the company itself, not by the shareholders individually, although in turn the shareholders together have ownership of the company. The shares express the shareholders’ proprietary relationship with the company.

In principle, shares are transferable, but in practice there are often restrictions on transfer, found in the company’s articles of association.

The principal rights that usually attach to a share are rights to dividends declared, a right to vote and a right to share in the company’s assets in a winding up. The principal responsibility that attaches to a share is to pay what is due on the share. The rights and duties are all subject to the memorandum and articles of association.

For a company limited by shares, the share capital must be stated in a fixed amount. In *Ooregum Gold Mining Co of India v Roper* [1892] A.C. 125 Lord Halsbury said

> ‘The capital is fixed and certain, and every creditor is entitled to look at that capital as his security.’

A share certificate is prima facie evidence of ownership of a share. However, it does not, of itself, constitute ownership of the share and is not essential to demonstrate that share capital has been issued. In order to be a member of a company, under the Companies Act, a person must be entered in the company’s register of members. See s22, Companies Act 1985 (s112 Companies Act 2006). The decision in *National Westminster Bank plc v CIR* ([1994] STC 580), confirms this position, i.e. the ‘issue’ of share capital is only complete when members are recorded in the company’s register of members.

The reader should note that the Companies Act 2006 abolishes the requirement for a company to have an authorised share capital by the repeal of section 2(5)(a). This should take effect from 1 October 2008. The new act nonetheless requires that, on formation, a company with a share capital will be required to submit a statement of capital and initial shareholdings to the Registrar at

Companies House.

Characteristics of issued share capital in a body incorporated in another country – relevant factors

When looking at whether a body incorporated under the law of another country, it is self evident that UK company law is not directly applicable. In *Ryall v The Du Bois Co Ltd* 18 TC 431, Lord Hanworth M.R. said

> 'a share in a foreign company may be something different from and, indeed, is almost necessarily different from, a share as we know it in an incorporated company.'

Slesser L.J. said

> 'we have to consider what would be analogous to stocks and shares in Germany in dealing with what is a company, and allowing for differences of law in that country'.
>
> Slesser L.J.'s comments were given in the statutory context of whether foreign income was income from stocks and shares for the purposes of Case V Schedule D. However we consider them as authority for proceeding by analogy in deciding whether the capital of a foreign company can be considered as 'issued share capital'.

A number of factors are relevant in deciding whether or not a foreign 'company' has 'issued share capital'.

Firstly the body concerned must have a legal personality separate and distinct from that of its members, able to carry on business and owning its assets in its own right, in the same way as a UK company. If that characteristic is absent the members cannot have the type of proprietorial interest which is characteristic of holders of issued share capital of a company incorporated under the laws of the UK.

If the body concerned possesses a separate legal personality, as described above, the following factors will then become relevant to the question of whether a member's interest in such company is analogous to an interest in 'issued share capital' as understood in the UK:

- whether the member's interest is like shares (that is, a portion of the fixed capital of the corporate body) or like debt (that is, money owed by the body corporate to the members)
- whether any subscription for the members' interests is payable
- whether the subscription payable for the 'shares' remains the member's property or whether it becomes the property of company
- what proprietary rights, such as rights to participate in control by voting, rights to receive a dividend out of the company's profits and rights to share in a distribution out of the company's assets in the event of a winding up, attach to the member's interests and what responsibilities, such as a responsibility to pay up on the 'share' if called, attach to the member
- whether the member's interest can be legally evidenced in accordance with local laws; for example, by being registered in a company-held document, or with a public authority, or by a certificate or similar document
- whether the member's interest is denominated in a stated fixed value
- whether the member's interest forms a fixed and certain amount of capital, or a part of that, to which creditors can look as security

- whether the non-UK law concerned requires amounts subscribed to be allocated to capital of the company which is fixed capital, and the extent to which subscriptions are so allocated
- whether the member's interests is capable of transfer and if so whether such a transfer would be similar to a transfer of a portion of the capital of the company, with attendant proprietary rights, rather than similar to a transfer of money or a loan account; and
- any other factors which point to the member's interests being 'issued' and having the character of ordinary share capital.

The background information a company or its advisers are likely to want to consider includes the following documentation:

- The corporate law of the foreign country which governs the body in question.
- Whatever general commentaries are available on the legal and commercial status of the body in question.
- The documents establishing the body, and any other documents which regulate its activities, especially those which deal with subscription for capital and those which govern what happens to the profits and assets of the body.

The accounts that show the state of affairs of the body, in particular the balance sheet, may be helpful in showing whether, and to what extent, money subscribed or otherwise provided by the members of the body is allocated to a fixed amount of permanent capital or whether it is loan debt.

In deciding whether the body has issued share capital, it is not necessary for every factor to be present, but there should be a preponderance of indicators pointing to there being issued share capital. Different weight may need to be given to the various factors. For instance it would be of considerable importance if the member's interest had the character of debt. However restrictions on transfer of a member's interest would be of lesser importance. It is by no means uncommon for there to be restrictions on transfer of shares in a UK company.

62.15.3 *Ordinary share capital: Delaware LLC*

HMRC Brief 54/07 provides:

Delaware Limited Liability Companies

There is an article about Delaware Limited Liability Companies (DLLC) in Tax Bulletin 51. Section 18-702c of the Delaware Limited Liability Act provides that

> 'Unless otherwise provided in a limited liability company agreement, a member's interest in a limited liability company may be evidenced by a certificate of limited liability company interest issued by the limited liability company.'

If a DLLC issues "shares" in this way and the other factors relating to the company suggest that it has share capital then we will accept that these "shares" may be regarded as "ordinary share capital" for the purpose of Section 832 ICTA 1988.

It should be noted that not all DLLCs issue share certificates but they may still have "ordinary share capital". Regard must be had to the particular terms of the agreement by which the LLC has been created. In any case of doubt or difficulty regarding the status of the share certificates HMRC will advise in particular cases in line with Code of Practice 10.

Other States within the United States of America have comparable legislation to Delaware. Where it can be shown that a particular State has legislation analogous to the Delaware legislation with which we are familiar, HMRC would expect to be able to provide advice in line with that for DLLCs.

62.15.4 *Ordinary share capital: German GmbH*

HMRC Brief 54/07 provides:

Gesellschaft mit beschränkter Haftung – GmbH

A Gesellschaft mit beschränkter Haftung (GmbH) in Germany, literally a 'company with limited liability', is an entity of a very similar kind to a UK private limited liability company. An Aktiengesellschaft (AG), sometimes called a "joint stock company" may be considered more akin to a UK public limited liability company (plc) as its stock may be listed.

Under German law, the capital of a GmbH is not divided up into small units. However, a GmbH has a fixed amount of capital (Stammkapital) which corresponds to the maximum amount of share capital that the company may issue, similarly to a UK limited liability company's "authorised share capital". The amounts originally contributed (Stammeinlagen) by the members (Gesellschafter) will also be noted, just as in the UK the initial subscriber shares will be noted in the memorandum of a limited liability company.

Article 5 of the German GmbH law sets out a minimum amount of Stammkapital (authorised share capital) as €25,000, and the minimum amount of Stammeinlage (original contribution/subscription) of each Gesellschafter (member) at €100.

Based upon GmbH cases HMRC has previously considered, the amounts of Stammeinlage subscribed by the members may normally be regarded as issued share capital for the purposes of the Taxes Acts.

Note

The above information has been set out in order to assist companies and their advisers understand HMRC's present interpretation of section 832 ICTA 1988 in the context of non-UK entities. The above note reflects our approach as taken in the context of a number of particular cases. Due to the particular facts that will be relevant in each individual case it is not possible for HMRC to offer a general advisory service in respect of other kinds of body throughout the world.

CHAPTER SIXTY THREE

"CONTROL", "CONNECTED", "CLOSE" AND RELATED EXPRESSIONS

63.1 Introduction

This chapter considers definitions of the following terms:

- control;
- associate;
- connected person;
- participator;
- loan creditor;
- close company.

The definitions overlap and cross-refer but they need to be considered separately.

63.2 Control – Introduction

Control of a company is a concept used so often in tax legislation that it is impossible to write a full list. The concept is important in particular in the definition of close company and the definition of connected person.

There are two definitions of control in the Taxes Acts. The legislation does not have terminology to describe them, so I coin the following terminology:

(1) "**Control in the ultra-wide sense"**– the definition in s.416 ICTA.
(2) **"Control in the strict sense"** – the definition in s.995 ITA.

Section 989 ITA provides:

> The following definitions apply for the purposes of the Income Tax Acts—
> "control", in relation to the control of a body corporate or a partnership, is to be read in accordance with section 995,

Thus for IT the strict sense is the default meaning, though in practice the ultra-wide sense is the more common usage.[1]

By contrast, s. 288(1) TCGA provides:

> In this Act, unless the context otherwise requires—
> "control" shall be construed in accordance with section 416 of the Taxes Act;

Thus for CGT the ultra-wide sense is the default meaning. For IHT, s.269 IHTA provides yet another definition of control which is not discussed here as control is not so important for IHT purposes. Such is the patchwork nature of UK taxation.

63.3 Control in the strict sense

Section 995 ITA provides:

> (1) This section has effect for the purposes of the provisions of the Income Tax Acts which apply this section.
> (2) In relation to a body corporate ("company A"), "control" means the power of a person ("P") to secure—
> (a) by means of the holding of shares or the possession of voting power in relation to that or any other body corporate, or
> (b) as a result of any powers conferred by the articles of association or other document regulating that or any other body corporate,
>
> that the affairs of company A are conducted in accordance with P's wishes.
> (3) In relation to a partnership, "control" means the right to a share of more than half the assets, or of more than half the income, of the partnership.

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1 For completeness, s.719 ITEPA provides:

> Section 995 of ITA 2007 (meaning of "control") applies for the purposes of this Act, unless otherwise indicated.

But this is otiose since s.989 ITA provides an IT-Acts-wide definition.

For corporation tax the definition is in s.840 ICTA.

63.4 Control in the ultra-wide sense

63.4.1 *Five heads of definition of control*

Section 416(2) ICTA provides:

> [A] For the purposes of this Part, a person shall be taken to have control of a company if
> [i] he exercises,[2] or
> [ii] is able to exercise or
> [iii] is entitled to acquire,
> direct or indirect control over the company's affairs,
> [B] and in particular, but without prejudice to the generality of the preceding words, if he possesses or is entitled to acquire-
> (a) the greater part
> [i] of the share capital or issued share capital of the company or
> [ii] of the voting power in the company; or
> (b) such part of the issued share capital of the company as would, if the whole of the income of the company were in fact distributed among the participators (without regard to any rights which he or any other person has as a loan creditor), entitle him to receive the greater part of the amount so distributed; or
> (c) such rights as would, in the event of the winding-up of the company or in any other circumstances, entitle him to receive the greater part of the assets of the company which would then be available for distribution among the participators.

Para [A] refers to a person who is *able to exercise* or is entitled to acquire control; para [B] refers to a person who *possesses* or is entitled to acquire certain rights; but there is no difference in meaning. Presumably the drafter thought that the correct legal terminology is that one *exercises* control but one *possesses* rights.

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2 Section 416(2)[A][i] is otiose for any person within [i], who *exercises* control, must also be within [ii], *able to exercise* control. But it does not matter.

The CT Manual identifies the five heads of control:

> **60210. Control: Definition**
> Control is defined under several headings:
> [1] Control over the affairs of the company (see CTM60220).
> [2] Control through voting power (see (a) of CTM60220).
> [3] Control through share capital or through issued share capital (see (b) of CTM60220).
> [4] Control over income of the company (see (c) of CTM60220).
> [5] Control over assets of the company (see (d) of CTM60220).

63.4.2 *Control over a company's affairs*

> *a person shall be taken to have control of a company if he exercises, or is able to exercise or is entitled to acquire, direct or indirect control over the company's affairs,*

The CT Manual provides:

> **60220. Control: Over the company's affairs**
> The House of Lords' judgment in the case of *R v IRC ex parte Newfields Developments Ltd* 73 TC 532 makes it clear that Section 416(2) ICTA 1988 approaches the question of control of a company from two angles. It begins with the proposition in the opening words of Section 416(2) that a person has control of a company if he or she exercises or is able to exercise or is entitled to acquire control, whether direct or indirect, over the company's affairs. That is a test of actual control, reflecting its meaning in ordinary speech.
> As regards the level at which control is exercised, the judgment in *Steele v EVC International NV* 69 TC 88 confirms that what is required is control at the participator or general meeting level, not at administrative or board level.

Similarly, SP 1/01 provides:

> 35. The manager must act for the non-resident in an independent capacity. This means ascertaining whether, having regard to its legal, financial and commercial characteristics, the relationship between the manager and the non-resident is a relationship between persons carrying on independent businesses that deal with each other on arm's length terms.

CT Manual para 60220 continues:

> The rest of Section 416(2) ICTA 1988, (4), (5) and (6) go on to widen the scope of the simple notion of control "enormously" (as Lord Hoffmann said in his judgment in the Newfields case). It means that it can apply to people who have no real control over the company's affairs but who shall be 'taken to have control of a company'.
> [The manual summarises s.416(2)[B] and concludes:]
> In Lord Hoffmann's words, 'the intention of the legislature was to spread the net very wide' (p556).

Similarly, SP 1/01 provides:

> 54. Where the establishment of a connected person's relationship depends on the question of whether a person falls to be regarded as having control of a company's affairs within the terms of s 416(2) TA 1988, it is not considered that a person's ability (whether de facto or de jure) to appoint the majority of the Board of directors will itself constitute control of the company's affairs—unless, that is, the Board exercises powers which would normally be exercised by the shareholders at a general meeting.

63.4.3 *Shares*

> *a person shall be taken to have control of a company ... if he possesses or is entitled to acquire ... the greater part of the share capital or issued share capital of the company ...*

This is straightforward.

63.4.4 *Votes*

> *a person shall be taken to have control of a company ... if he possesses or is entitled to acquire ... the greater part of ... the voting power in the company*

This is otiose, since a person with the greater part of the votes has control under s.416(2)[A]: he is able to exercise control over the company's affairs.

63.4.5 *Right to income*

> *a person shall be taken to have control of a company ... if he possesses or is entitled to acquire ... such part of the issued share capital of the company as would, if the whole of the income of the company were in fact distributed among the participators (without regard to any rights which he or any other person has as a loan creditor), entitle him to receive the greater part of the amount so distributed*

The CT Manual provides:

> The test in (c) of CTM60220 depends on the dividend rights of the issued capital and will be mainly of interest where shares with no voting rights carry the right to a high dividend.

But this is not the only case. The life tenant of an IP trust holding a majority of the shares in a company in principle has control of the company under this head.

63.4.6 *Right to company assets*

> *a person shall be taken to have control of a company ... if he possesses or is entitled to acquire... such rights as would, in the event of the winding-up of the company or in any other circumstances, entitle him to receive the greater part of the assets of the company which would then be available for distribution among the participators.*

The CT Manual provides:

> **60230. Control: Right to receive most assets**
> Control under (d) of CTM60220 exists where a person or persons have a right to receive the greater part of the assets then available for distribution among participators, in any circumstances, (for example, on redemption of redeemable share capital or on repayment of loans to the company) but also, specifically, on a winding up of the company.
> ‘Participators’ for this purpose includes loan creditors (unlike (c) of CTM60220). As regards the definition of loan creditors, see CTM60130. If a loan creditor is an open company, see CTM60300.
> The test under Section 416(2)(c) ICTA 1988 only applies to the assets that would come to a participator in that capacity. In the case of a bank, for example, no regard would be had to any assets that would come to

> it in respect of loans made in the ordinary course of its banking business, because it is not deemed to be a loan creditor (and, hence it is not a participator) in respect of such loans by virtue of Section 417(9) ICTA 1988.
>
> **60240. Control: Summary**
>
> ... 3. The test in CTM60230 will normally be of interest only where loan creditors are participators (see CTM60130) or there exist special rights to participate in the assets available for distribution in a winding-up or in any other circumstances for example, on redemption of redeemable share capital.

But this is not the only case. If trustees hold a company on trust for A for life, remainder to B absolutely, then B has control under this head: for he will in the future be entitled to the assets of the company. If trustees hold a company on trust for B contingently (eg on attaining the age of 25, if B is under 25) then B does not have control under this head.

63.4.7 *Duplicate control*

The CT Manual provides:

> **60250. Control: In multiple**
>
> More than one person or one group of persons may 'control' a company. For example, one person may have the greater part of the voting power, while two people hold the greater part of the issued share capital and a group of three people are entitled to the greater part of the assets in a winding up. All three combinations of people can be taken to have control of the company at the same time.

63.4.8 *Control by two or more persons*

Section 416(3) ICTA provides:

> Where two or more persons together satisfy any of the conditions of subsection (2) above, they shall be taken to have control of the company.

It is often necessary to ask if a company is under the control of the same persons so one must identify which people together control a company. The CT Manual para 60250 explains the approach to this issue:

> If say three persons, A, B and C, each hold one third of the shares in a company, and they are not connected in any way which would allow the rights and powers of one to be attributed to another, then control is held by A and B, or B and C, or A and C but not A, B and C together.
> This is because in determining whether companies are 'associated companies', you should only consider 'minimum' controlling combinations. You should disregard combinations containing superfluous members. For example, a company controlled by the unconnected persons A, B and C, but not by any one or two of them alone should not be regarded as associated with any company controlled by one of them alone (as in the first subparagraph above) or by any two of them (as in the second subparagraph above). (See also CTM03730 for an example of this.)

This passage is written in the context of s.13(4) ICTA which provides:

> for the purposes of this section a company is to be treated as an "associated company" of another at a given time if at that time one of the two has control of the other or both are under the control of the same person or persons.

The same approach would apply to the definition of connected person: see 63.12 (Connection with companies).

63.4.9 *Future rights*

Section 416(4) ICTA provides:

> For the purposes of subsection (2) above a person shall be treated as entitled to acquire anything which he is entitled to acquire at a future date, or will at a future date be entitled to acquire.

63.5 "Nominees"

Section 416(5) ICTA provides:

> For the purposes of subsections (2) and (3) above, there shall be attributed to any person any rights or powers of a nominee for him, that is to say, any rights or powers which another person possesses on his behalf or may be required to exercise on his direction or behalf.

It is self-evident that the powers of a nominee should be attributed to his principal. The section is in fact wider than that, since the cases where "A may be required to exercise rights at the direction of B" extend beyond the case where A is a nominee for B in the strict sense of nominee. However the subsection is otiose, for if A may be required to exercise rights on the direction of B, or on behalf of B, then these are rights which B possesses or is entitled to acquire, so the rights would be taken into account in any event in the test of control.

63.6 Meaning of "associate"

Section 417(3) ICTA provides:

> For the purposes of this Part "associate" means, in relation to a participator—
> (a) any relative or partner of the participator;
> (b) the trustees of any settlement in relation to which the participator is, or any relative of his (living or dead) is or was, a settlor; and
> (c) where the participator is interested in any shares or obligations of the company which are subject to any trust, or are part of the estate of a deceased person—
> (i) the trustees of the settlement concerned or, as the case may be, the personal representatives of the deceased; and
> (ii) if the participator is a company, any other company interested in those shares or obligations;
>
> and has a corresponding meaning in relation to a person other than a participator.

The reference to "participator" is just a confusing irrelevance, as the last words make clear.

Section 417(4) ICTA defines relative:

> In subsection (3) above "relative" means spouse or civil partner, parent or remoter forebear, child or remoter issue, or brother or sister.

(Contrast the definition of relative in the definition of connected person, under which a spouse is not a relative;[3] but one can get to the same result with either definition.).

63.7 Attribution of rights of associates and controlled companies

Section 416(6) ICTA provides:

> [a] For the purposes of subsections (2) and (3) above, there may also be attributed to any person all the rights and powers
> [i] of any company of which he has, or he and associates of his have, control or any two or more such companies[4], or
> [ii] of any associate of his or of any two or more associates of his[5],
> [b] including those attributed to a company or associate under subsection (5) above, but not those attributed to an associate under this subsection;
> [c] and such attributions shall be made under this subsection as will result in the company being treated as under the control of five or fewer participators if it can be so treated.

Although this rule is said to apply for the purposes of s.416(2)(3), in fact it applies for all purposes of the definition of control in s.416. On the other hand, this rule does not apply for the purposes of the definition of participator (that is, the fact that A is an associate of a participator does not mean that A is a participator).

The CT Manual provides:

> However deciding on the 'minimum' controlling combination for any of the tests set out at ICTA 1988/416(2)(a) to (c) does not mean you have to establish the smallest controlling combination of each company when determining whether companies are associated companies.
> In his High Court judgment in *R v IRC ex parte Newfields Developments Ltd* (73 TC 532 at page 541B) Moses J said that Section 416 [ICTA] had to be exercised for the statutory purposes for which it was conferred:

---

3 See 63.9 (Family members).

4 The words "or any two or more such companies" are otiose as the singular would include the plural.

5 The words "or any two or associates of his" are otiose as the singular would include the plural.

> "In the context of Section 13 [ICTA], that purpose is to ascertain whether, in the instant case, two companies are under the control of the same person pursuant to Section 13(4). That is the statutory question. If it is possible to answer that in the affirmative, by exercising the power of attribution, in my judgment, that power must be exercised. Conversely, if that question, namely, are the two companies under the control of the same person, can only be answered in the affirmative by refraining from the exercise of the power, then the power should not be exercised".

So in the first sub-paragraph above, you may be able to determine that two companies are associated because the three people who together have an entitlement to the greater part of the assets in a winding up also together hold the greater part of the voting power in another company. In that case you would take this group as controlling the company and not the single or two person combinations. As this example shows, the identical controlling combination does not need to be established by the same test in each company.

63.7.1 *Commentary*

This attribution rule – more than any other – is what makes the definition of control ultra-wide. It is so wide that the word "control" is not apt to describe the concept ("loosely associated" would be nearer the mark.) For instance:

(1) A has control of a company owned by a relative (say, a sister in law) even though he has no beneficial interest in the company.

(2) A has control of a company owned by a trust of which a relative is a settlor, even though he is not a beneficiary and has no right to know that the trust had been made, let alone to know anything about the trust property. Indeed the relative need not be the settlor but only *a* settlor, so the rule would apply if a sister in law provides a nominal amount of property to a trust.

This has two malign consequences. The first is practical: it is often not possible for a person to know whether he controls a company or not or to draw up a list of all companies which he controls. In practice there is no doubt substantial innocent non-compliance. The second point is presentational but nevertheless important: anti-avoidance provisions which refer to control may appear to the non-tax specialist to be reasonable because control seems a sensible limiting factor; but they generally operate unreasonably widely (because the meaning of *control* is so wide). The same applies to provisions using the term "connected person" (so far as that term uses the word "control").[6] But there it is. Where this ultra-wide sense of control is relevant, one might refer to it as "control" using scare quotation marks.

63.8 Connected person

63.8.1 *Introduction*

"Connected person" is defined for CGT in s.286 TCGA. Section 286(1) TCGA provides:

> [a] Any question whether a person is connected with another shall for the purposes of this Act be determined in accordance with the following subsections of this section ...

For IT, s.993 ITA provides:

> **993 Meaning of "connected" persons**
> (1) This section has effect for the purposes of the provisions of the Income Tax Acts which apply this section.

So for IT the definition applies only if expressly incorporated: it is not an ITA-wide definition.

The IT definition is substantially the same as the CGT definition but the drafting is improved in some respects. Where they are the same, I give the text of the TCGA and the IT provision in footnotes.

Section 839 ICTA sets out the definition for the purposes of the corporation tax acts. It is substantially the same as the IT definition and is not discussed further in this book.

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6 See for instance the Substantial Donors to Charity Consultation Responses Document, 2 January 2009 para 3.12, [2009] STI 65, where charities describe the connected persons rule as it applies in that context as an "impossible requirement", a "substantial administrative burden" and a "compliance nightmare".

IHT adopts the CGT definition of "connected person" with a little tinkering.[7]

There are five heads of the definition of connected person:

(1) Family members
(2) Trustees
(3) Companies held by trusts
(4) Partnerships
(5) Companies generally

63.8.2 *Reciprocity of connection*

Section 286(1) TCGA continues:

> [b] (any provision that one person is connected with another being taken to mean that they are connected with one another).

The effect of s.286(1)[b] is that "connected" has a reflexive status: if A is connected to B then B is connected to A. Section 994(4) ITA is more clearly drafted for IT:

> If any provision of section 993 provides that a person ("A") is connected with another person ("B"), it also follows that B is connected with A.

63.9 Connection with family members

Section 286(2) TCGA provides:

> A person is connected with an individual if that person is
> [a] the individual's spouse or civil partner,
> [b] or is a relative,
> [c] or the spouse or civil partner of a relative,

---

7 Section 270 IHTA provides:

> "For the purposes of this Act any question whether a person is connected with another shall be determined as, for the purposes of the 1992 Act] it falls to be determined under section 286 of that Act, but as if in that section 'relative' included uncle, aunt, nephew and niece and 'settlement', 'settlor' and 'trustee' had the same meanings as in this Act."

[i] of the individual or
[ii] of the individual's spouse or civil partner.[8]

The CG Manual unpacks this definition:

> **14581. Relatives [March 2006]**
> A person is connected with an individual if that person is
> [1] the individual's spouse or civil partner
> [2] a relative of the individual
> [3] the spouse or civil partner of a relative of the individual
> [4] a relative of the individual's spouse or civil partner
> [5] the spouse or civil partner of a relative of the individual's spouse or civil partner.

Section 286(8) TCGA provides:

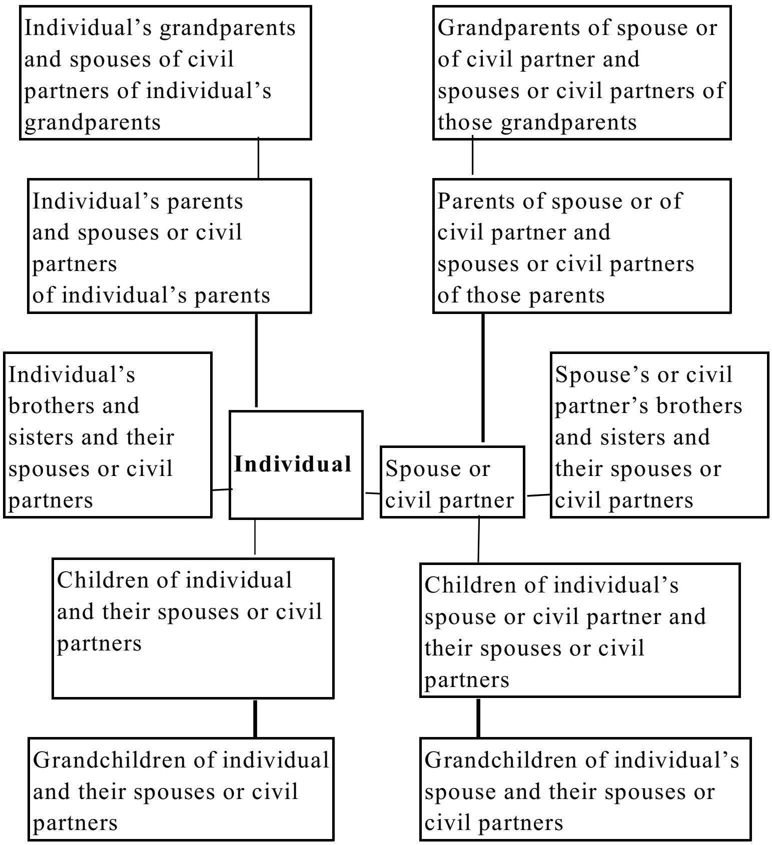
> In this section "relative" means brother, sister, ancestor or lineal descendant.

The CG Manual provides:

> **14582. Relatives**
> ... The term 'relative' does not cover all family relationships. In particular, it does not include nephews, nieces, uncles and aunts.
> **14583. Relatives [March 2006]**
> [This illustrates the provision by a diagram]

---

8 For IT, s.993(2) provides similarly:
An individual ("A") is connected with another individual ("B") if—
(a) A is B's spouse or civil partner,
(b) A is a relative of B,
(c) A is the spouse or civil partner of a relative of B,
(d) A is a relative of B's spouse or civil partner, or
(e) A is the spouse or civil partner of a relative of B's spouse or civil partner.



Readers are invited to speculate whether this diagram is or is not a useful aid to comprehension.

For the definition of control for IHT purposes, "relative" also includes an aunt, uncle, nephew and niece. See s.270 IHTA. A two-dimensional diagram could not do justice to that.

63.10 Connection with trustees

Section 286(3) TCGA provides:

> A person, in his capacity as trustee of a settlement, is connected with-
> (a) any individual who in relation to the settlement is a settlor,
> (b) any person who is connected with such an individual,
> (c) [this concerns companies in which the trustees are interested – see

below]

The next two paragraphs deal with sub-fund provisions so are dead letter law:

> (d) if the settlement is the principal settlement in relation to one or more sub-fund settlements, the trustees of the sub-fund settlements, and
> (e) if the settlement is a sub-fund settlement in relation to a principal settlement, the trustees of any other sub-fund settlements in relation to the principal settlement.[9]

The CG Manual provides:

> **14592. Trustees [June 2005]**
> ... The trustees are no longer connected to the persons connected to the settlor after the settlor has died.

More accurately, trustees are not connected to family members or other persons who would have been connected to the settlor when he was alive.[10]

The CG Manual provides:

> **14593. Trustees**
> A settlor is considered to be connected with the trustee at the moment when property is put into the settlement.
> **14594. Trustees [March 2006]**
> For the purposes of determining whether a trustee is connected with an individual, the identity of the trustee is irrelevant. So, for example, if the trustee is the wife or civil partner of the individual, he or she is only

---

9 For IT, s.993 ITA provides similarly:

> (3) A person, in the capacity as trustee of a settlement, is connected with—
> (a) any individual who is a settlor in relation to the settlement,
> (b) any person connected with such an individual,
> ...
> (f) if the settlement is the principal settlement in relation to one or more sub-fund settlements, a person in the capacity as trustee of such a sub-fund settlement, and
> (g) if the settlement is a sub-fund settlement in relation to a principal settlement, a person in the capacity as trustee of any other sub-fund settlements in relation to the principal settlement.

10 Contrast the definition of associates. See 63.6 (Meaning of "associate").

> connected in his or her capacity as trustee if the case is within one of the three cases in CG14590.

This is correct since trustees are regarded as distinct from the persons who are actually the trustees. The CG Manual provides:

> **14595. Trustees**
> Although under the tests outlined an individual is not connected with particular trustees, this may not prevent him or her from being connected with a company controlled by the trustees.

This is correct: see 63.12 (Connection with companies). The Manual continues:

> Under ICTA 1988, S 417, a beneficiary of a trust can be attributed with the rights and powers of trustees. In such circumstances he or she may control the company through the tests in ICTA 1988, S 416 and ICTA 1988, S 417 and hence be connected under TCGA 1992, S 286.

There is no general rule that the rights of trustees are attributed to beneficiaries. However the attribution will often be made on the grounds that the beneficiaries are relatives of the settlor[11] or (sometimes) that they possess the rights to income or capital.[12]

Suppose:

(1) A creates a trust (trust A) and
(2) B, (who is connected to A, eg a spouse) creates a trust (trust B).

A is connected to the trustees of trust A (he is the settlor). A is connected to the trustees of trust B (an individual person is the settlor). However the trustees of trust A are not connected to the trustees of trust B. For the position if the trusts own companies, see 63.12.4 (Connected trusts owning separate companies).

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11 See 63.7 (Attribution of rights of associates and controlled companies).
12 See 63.4.5 (Right to income); 63.4.6 (Right to company assets)..

63.10.1 *Company connected with settlement*

Section 286(3) TCGA provides:

> A person, in his capacity as trustee of a settlement, is connected with ...
> (c) any body corporate which is connected with that settlement,

I do not know why the subsection refers to body corporate rather than company, but I don't think it makes any difference. This takes us to s.286(3A) TCGA which provides:

> For the purpose of subsection (3) above a body corporate is connected with a settlement if-
> (a) it is a close company (or only not a close company because it is not resident in the UK) and the participators include the trustees of the settlement; or
> (b) it is controlled (within the meaning of section 840 of the Taxes Act) by a company falling within paragraph (a) above.

It is confusing that the drafter used the expression "connected with a settlement" since the term "connected" is not used here in the normal CGT sense. Section 993(3) ITA makes the same point but is more clearly drafted:

> A person, in the capacity as trustee of a settlement, is connected with ...
> (c) any close company whose participators include the trustees of the settlement,
> (d) any non-UK resident company which, if it were UK resident, would be a close company whose participators include the trustees of the settlement,
> (e) any body corporate controlled (within the meaning of section 995) by a company within paragraph (c) or (d)

63.10.2 *Meaning of settlement and trustee*

Section 286(3ZA) TCGA provides:

> For the purpose of subsection (3) above—
> (a) "settlement" has the same meaning as in section 620 of ITTOIA 2005, and

(b) "trustee", in relation to a settlement in relation to which there would be no trustees apart from this paragraph, means any person in whom the settled property or its management is for the time being vested.

One wonders why the decision was made in 2006 to disapply the standard IT/CGT definition of settlement and apply the settlement-arrangement definition. (Contrast the definition of associate.) Needless to say, no reason was given at the time. One consequence is that settlements made without bounty, and will trusts, are not settlements for the purposes of the connected persons rules, but that can hardly be the reason for the change.

For the definition of control for IHT purposes, "settlement" "settlor" and "trustee" have their IHTA meanings: s.270 IHTA.

63.11 Connection with partnerships

Section 286(4) TCGA provides:

> Except in relation to acquisitions or disposals of partnership assets pursuant to bona fide commercial arrangements, a person is connected with
> [a] any person with whom he is in partnership,
> [b] and with
> [i] the spouse or civil partner
> [ii] or a relative
> of any individual with whom he is in partnership.[13]

63.12 Connection with companies

Apart from the rule connecting trustees to companies, s.286 TCGA provides four ways by which a company may be connected to another person. In summary:

[13] For IT, s.993 (4) ITA provides similarly:
"A person who is a partner in a partnership is connected with—
(a) any partner in the partnership,
(b) the spouse or civil partner of any individual who is a partner in the partnership, and
(c) a relative of any individual who is a partner in the partnership.
But this subsection does not apply in relation to acquisitions or disposals of assets of the partnership pursuant to genuine commercial arrangements."

(1) connection between companies with common controller or connected controller;
(2) connection between companies with groups of connected controllers;
(3) connection between company and its controller;
(4) acting together to exercise control.

For completeness: the usual definition of company is disapplied for the purposes of s. 993 and 994 ITA (though not for CGT purposes).[14] So s. 994 needs to provide its own definition of company,[15] but since the definition is the same as the standard definition, this drafting quirk makes no difference. Perhaps some day someone will tidy up this mess, but it does not really matter.

Since "control" has the ultra-wide sense, this head of the definition of connected person is also ultra-wide and no-one can draw a complete list of all the companies which they "control".

63.12.1 *Common control or connected controllers*

Section 286(5)(a) TCGA provides:

> A company is connected with another company-
> (a) [i] if the same person has control of both, or
> [ii] [A] a person has control of one and
> [B] persons connected with him, or he and persons connected with him, have control of the other,

63.12.2 *Groups of connected controllers*

Section 286(5)(b) TCGA provides:

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14 See 62.1.4 (Definitions of company)

15 Section 994 provides:

"(1) In section 993 and this section—
"company" includes any body corporate or unincorporated association, but does not include a partnership (and see also subsection (2)),...
(2) For the purposes of section 993—
(a) a unit trust scheme is treated as if it were a company, and
(b) the rights of the unit holders are treated as if they were shares in the company."

A company is connected with another company...
(b) if
[i] a group of 2 or more persons has control of each company, and
[ii] the groups either
[A] consist of the same persons or
[B] could be regarded as consisting of the same persons by treating (in one or more cases) a member of either group as replaced by a person with whom he is connected.

63.12.3 *Control*

Section 286(6) TCGA provides:

A company is connected with another person, if
[a] that person has control of it or
[b] if that person and persons connected with him together have control of it.[16]

63.12.4 *Connected trusts owning separate companies*

Suppose:

(1) A creates a trust (trust A) which owns a company (A Ltd) and
(2) B (who is a relative or spouse of A) creates a trust (trust B) which owns a company (B Ltd), thus:

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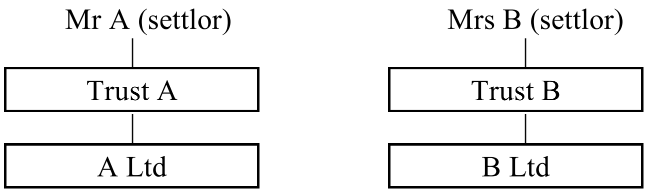
16 For IT, s.883 ITA provides similarly:
(5) A company is connected with another company if—
(a) the same person has control of both companies,
(b) a person ("A") has control of one company and persons connected with A have control of the other company,
(c) A has control of one company and A together with persons connected with A have control of the other company, or
(d) a group of two or more persons has control of both companies and the groups either consist of the same persons or could be so regarded if (in one or more cases) a member of either group were replaced by a person with whom the member is connected.
(6) A company is connected with another person ("A") if—
(a) A has control of the company, or
(b) A together with persons connected with A have control of the company.



The analysis is as follows:

(1) A is connected to Trust A (he is the settlor).
(2) A is connected to A Ltd (the trustees of trust A are associates of A because he is the settlor; so their rights are attributed to him; so he has control of A Ltd; so he is connected with it).
(3) A is connected to the trustees of trust B (a connected person is the settlor).
(4) A is connected to B Ltd (the trustees of trust B are associates of A because a relative is the settlor; so their rights are attributed to him; so he has control of B Ltd; so he is connected with it).
(5) A Ltd is connected with B Ltd (because A has "control" of both.)

The trustees of trust A are not connected to the trustees of trust B but that does not stop their companies from being connected. Note that it is not necessarily possible for A Ltd or the trustees of trust A to know that A Ltd is connected with B Ltd.

What if A and B have died? If there is any person alive who is a relative of A and B, as defined, the relative has control of both companies and so A Ltd and B Ltd are still connected. But if A and B have no relatives (as defined) then the two companies are not in principle connected.

63.12.5 *Acting together to secure control*

Section 286(7) TCGA provides:

> Any 2 or more persons acting together to secure or exercise control of a company shall be treated in relation to that company as connected with one another and with any person acting on the directions of any of them

to secure or exercise control of the company.[17]

The CG Manual provides:

> **14622. Companies: 2 or more persons acting together to control**
> Any two or more persons acting together to secure or exercise control of a company should be treated in relation to that company as connected with one another and with any person acting on the directions of any of them to secure or exercise control of the company. For this subsection to operate it is not sufficient for the persons to have control of the company, the persons do have to act in some way to control the company. However, for example, exercising control could mean refraining from voting in a particular way and so enabling another person to win a vote, as well as by actually voting.
> **14623. Directors of a company**
> [1] Directors of a company are not necessarily connected persons in relation to transactions between themselves. Whether or not one of them controls the company or two or more together control the company, they are not connected persons unless they are 'relatives', see CG14581, or partners, see CG14610.
> [2] TCGA 1992, S 286(7) makes two or more directors connected persons only in relation to transactions with the company.

Point [2] is not necessarily correct: it depends on whether the directors are acting together.

63.13 Why does it matter who is a participator?

The term "participator" is used throughout the Taxes Acts, and it is not practical to give a full list. For the purposes of this book the term is particularly important in the following contexts:

(1) The definition of "relevant person" for the ITA remittance basis.

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17 For IT, s.993(7) ITA provides similarly:

> "In relation to a company, any two or more persons acting together to secure or exercise control of the company are connected with—
> (a) one another, and
> (b) any person acting on the directions of any of them to secure or exercise control of the company."

(2) Section 13 TCGA (gains of non-resident companies attributed to participators).
(3) The test of whether trustees control a company.
(4) The definition of "close company".

63.14 Definition(s) of participator

Section 417(1) ICTA provides:

> For the purposes of this Part, a "participator" is, in relation to any company,
> [A] a person having a share or interest in the capital or income of the company,
> [B] and, without prejudice to the generality of the preceding words, includes—
> (a) any person who possesses, or is entitled to acquire, share capital or voting rights in the company;
> (b) any loan creditor of the company;
> (c) any person who possesses, or is entitled to acquire,
> [i] a right to receive or participate in distributions of the company (construing "distributions" without regard to section 418) or
> [ii] any amounts payable by the company (in cash or in kind) to loan creditors by way of premium on redemption; and
> (d) any person who is entitled to secure that income or assets (whether present or future) of the company will be applied directly or indirectly for his benefit.

This definition is expressed to apply for the purposes of "this Part", but it should be a taxes-Act-wide definition, because when the word participator is used, the definition is generally incorporated. Occasionally the definition is adopted with changes.

Thus s.419(7) ICTA provides a wider definition:[18]

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18 Section 417(2) ICTA somewhat unnecessarily flags this:

> The provisions of subsection (1) above are without prejudice to any particular provision of this Part requiring a participator in one company to be treated as being also a participator in another company.

> For the purposes of this section any participator in a company which controls another company shall be treated as being also a participator in that other company.

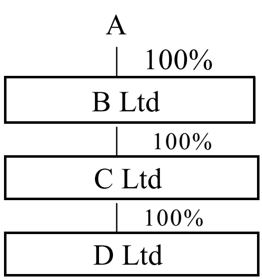
Section 418(8) ICTA provides a still wider definition:

> For the purposes of this section any reference to a participator includes an associate of a participator, and any participator in a company which controls another company shall be treated as being also a participator in that other company.

In this book I use the term "participator" in the s.417(2) sense unless otherwise specified. One might call that the "standard definition".

63.14.1 *Chain of wholly owned companies*

Suppose a chain of wholly owned companies:



C Ltd is a participator in D Ltd under s.417(1)[A] ICTA. But A and B Ltd are also participators in D Ltd, under s.419(1)[B](d) ICTA.[19] This is so wherever the companies are resident.

63.14.2 *Chain of partly owned companies*

Suppose a chain of partly owned companies which do not confer control, such as:

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19 This view is not universally held.

Example 1

A
| 100%
B Ltd
| 50% or less
C Ltd

Example 2

A
| 50% or less
B Ltd
| 100%
C Ltd

A is a participator in B Ltd. A does not control C Ltd[20] and it is considered that A is not a participator in C Ltd. It might be argued that the rights of a minority shareholder are such that A is a participator within s.417[B](d) – ie that A has the right to secure that the income of C Ltd is applied for his benefit. I refer to this as the "wide view". But this is very doubtful and in practice it appears that HMRC do not take the wide view. The CT Manual refers to the extended definitions of "participator"[21] and provides:

> **60110. Participator: Extended meaning of**
> The definition of a 'participator' is extended, so that a participator in a company which controls (see CTM60200 onwards) another company is to be treated as being also a participator in that other company, for the following purposes:
> - For the purposes of Section 418 ICTA 1988 (extended meaning of distributions for close companies, see CTM60500 onwards) in determining what are distributions.
> - For the purposes of Section 419 ICTA 1988 (loans to participators, etc, see CTM61500 onwards) as respects any loan or advance.
>
> If, for example, Company B holds all the issued share capital of Company T and Company T makes a loan to W, a shareholder in Company B, that loan is within Section 419 ICTA 1988 since W as well as being a participator in Company B is deemed also to be a participator in Company T.

This is essentially Example 2 above. It assumes that the wide view is not correct.[22]

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20 In the absence of special provisions in the company articles or shareholder agreements.

21 See above.

22 The drafter of s.809M(2)(e)[ii] ITA also seems to have assumed this is correct; see 10.4 (Relevant persons-family companies).

63.14.3 *Trustees and beneficiaries of trusts*

Suppose trustees hold shares in a company. The trustees are participators under s.417(1)[A]. A person holding shares as trustee is not a participator in his personal capacity since trustees are (at least for IT and CGT purposes) deemed to be a separate person.[23] Beneficiaries of the trust, other than merely discretionary beneficiaries, are also participators under s.417(1)[A] since they too have an interest in the trust property. This is clear from the statute but, for completeness, HMRC agree. The CT Manual para 60160 provides:

> **'Interested in'**
> The words 'interested in' have a wide meaning and, for example, where shares are held by trustees, the trustees, the beneficiaries and the remainderman (if any) of the trust are interested in the shares. Where shares are held by trustees under a will for persons in succession, the life tenant and the remainderman, as well as the trustees, are interested in the shares. (See, in this connection, *IRC v Park Investments Ltd* 43 TC 200, particularly the judgment of Danckwerts LJ at page 225, *IRC v Tring Investments Ltd* 22 TC 679, and *Alexander Drew and Sons Ltd v IRC* 17 TC 140.)

As to whether a person holding as nominee is a participator in his private capacity, see *Bramwell on Corporation Tax* para A.11.1.16.

63.14.4 *Personal representatives and beneficiaries of estates*

Suppose PRs hold shares in a company. The PRs are participators under s.417(1)[A]. A person holding shares as PR is also a participator in his private capacity, for IT purposes,[24] but not for CGT purposes as for CGT the PRs are deemed to be a separate person.

Beneficiaries of an estate are not participators under s.417(1)[A] since they do not have a legal or equitable "interest" (in the strict sense) in the assets of the estate. However they are participators under s.417[B](a)(d) by virtue of their right to compel administration of the estate.

The CT Manual para 60160 provides:

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23 *Bibby v IRC* 29 TC 167 is no longer applicable to trustees except, possibly, for IHT.

24 *Bibby v IRC* 29 TC 167.

> The executors or administrators are interested in the assets of a deceased person's estate during the period of administration (*Willingale v Islington Green Investment Co* 48 TC 547). The beneficiaries should be regarded as interested in any assets of the estate from which they may benefit.

63.14.5 *"Entitled"*

Section 417(1) ICTA provides:

> In this subsection references to being entitled to do anything apply where a person is presently entitled to do it at a future date, or will at a future date be entitled to do it.

The CT Manual provides:

> **60120. Entitled to acquire or secure**
> The words 'entitled to acquire' and 'entitled to secure' introduce the concept of a potential participator. So, for example, a person is a participator if, by means of a contractual right or by rights arising under a trust deed, they can:
> - require a shareholder to transfer shares to that person, or
> - secure the issue to that person of unissued capital of the company, or
> - secure that if the company makes a distribution or if a loan is redeemed by the company at a premium, that person has a share in the distribution or the premium.

Similarly, a person is a participator if by means of a contractual right or some other arrangement he can secure that income or assets of the company will be applied directly or indirectly for his benefit.

63.14.6 Loan creditor

63.14.7 *Why does it matter who is a loan creditor?*

The expression is used too often to set out a full list, but in particular:

(1) A loan creditor is a participator.
(2) The expression is used in the definition of close company.

63.14.8 *Definition of loan creditor*

Section 417(7) ICTA provides:

> Subject to subsection (9) below, for the purposes of this Part "loan creditor", in relation to a company, means a creditor in respect of any debt incurred by the company—
>
> (a) for any money borrowed or capital assets acquired by the company; or
>
> (b) for any right to receive income created in favour of the company; or
>
> (c) for consideration the value of which to the company was (at the time when the debt was incurred) substantially less than the amount of the debt (including any premium thereon);
>
> or in respect of any redeemable loan capital issued by the company.

The CT Manual paraphrases s.417(7) and continues:

> **60130. Loan creditor**
>
> A person is not a participator merely because he or she is a normal trade creditor of the company.
>
> As the normal debenture issued by a company is redeemable, debenture holders are participators.
>
> Payments to be made under a hire purchase agreement would not normally be regarded as part of the company's loan capital. This is because under the usual hire purchase agreement there will be no debt for capital assets acquired by the company. The terms of the typical agreement make it clear that the assets remain in the ownership of the hire company until the final instalment is paid. The payments not made in order to acquire a capital asset, but rather they are rent for the use of the asset.
>
> An example of a sum owing in the circumstances described in [s.417(7)(b)] is where a person contracts to make annual payments to the company, in return for a capital sum due at some later date. The capital sum is treated as loan capital of the company and the person will be a participator.
>
> ... It should be borne in mind that Section 209(2)(d) ICTA 1988 provides that the interest etc on certain loans is a distribution. As regards such loans, the creditor is in any case a participator as he or she 'possesses a right to receive or participate in distributions of the company' (see [s.417(1)[B](c)]).

63.14.9 *Interest in debt*

Section 417(8) ICTA provides:

> Subject to subsection (9) below, a person who is not the creditor in respect of any debt or loan capital to which subsection (7) above applies but nevertheless has a beneficial interest therein shall, to the extent of that interest, be treated for the purposes of this Part as a loan creditor in respect of that debt or loan capital.

The words "to the extent of that interest" make no sense, since a person either is or is not a loan creditor. One cannot be a loan creditor "to an extent". But it does not matter.

63.14.10 *Banking creditor*

Section 417(9) ICTA provides:

> A person carrying on a business of banking shall not be deemed to be a loan creditor in respect of any loan capital or debt issued or incurred by the company for money lent by him to the company in the ordinary course of that business.

The CT Manual para 60131 provides:

> ***Banking business***
> Where a company has borrowed money from a person, that person is a participator unless the person carries on the business of banking and made the loan in the ordinary course of that business (Section 417(9) ICTA 1988). There is no statutory definition of what constitutes carrying on a banking business (the definition of bank in Section 840A ICTA 1988 does not apply to Section 417 ICTA 1988) so we rely instead on the common characteristics of banking established in the (non-tax) case of *United Dominions Trust Ltd v Kirkwood* 1966 2 QB 431 and endorsed in *Hafton Properties Ltd v McHugh* 59 TC 420.
> If you have any queries on whether a person is carrying on a business of banking, or whether a loan is made in the ordinary course of that business, please consult CT&VAT (Technical).

63.15 Definition of close company

"Close company" is one of the most elaborately defined expressions in the taxes acts, and that is really saying something. The definition in s. 414 ICTA is for the purposes of the corporation tax acts. This is extended to income tax by s. 989 ITA:

> The following definitions apply for the purposes of the Income Tax Acts—
> "close company" has the same meaning as in the Corporation Tax Acts (see sections 414 and 415 of ICTA),

It is extended to CGT by s.288(1) TCGA:

> In this Act, unless the context otherwise requires—
> "close company" has the meaning given by sections 414 and 415 of the Taxes Act;

There are two main tests of close: the control test and the winding-up test.

63.16 The control test

63.16.1 *Control of five or fewer participators*

The starting point is s.414(1) ICTA which provides:

> For the purposes of the Corporation Tax Acts, a "close company" is one which is under the control of five or fewer participators ...

Control has the ultra-wide sense.

63.16.2 *Control of participators who are directors*

Section 414(1) ICTA provides:

> For the purposes of the Corporation Tax Acts, a "close company" is one which is under the control ... of participators who are directors ...

This takes us to the idiosyncratic definition of director in s.417(5) ICTA:

> [A] For the purposes of this Part "director" includes any person occupying the position of director by whatever name called, any person in accordance with whose directions or instructions the directors are accustomed to act,

So far this is a standard definition; but the text continues:

> [B] and any person who—
> (a) is a manager of the company or otherwise concerned in the management of the company's trade or business, and
> (b) is,
> [i] either on his own or
> [ii] with one or more associates,
> the beneficial owner of, or able, directly or through the medium of other companies or by any other indirect means, to control 20 per cent or over of the ordinary share capital of the company.
>
> (6) In subsection (5)(b) above the expression "either on his own or with one or more associates" requires a person to be treated as owning or, as the case may be, controlling what any associate owns or controls, even if he does not own or control share capital on his own.

A company controlled by director-participators is a close company, even if the number of director-participators exceeds five. Directors have "control" of a charitable company if (*inter alia*) they exercise direct or indirect control over the company's affairs. This is puzzling as (under standard articles)[25] company law directors manage the business of the company, and may exercise all the powers of the company. In one sense, directors always control their company. It cannot be that every company whose directors happen to be participators is made a close company under this part of the definition. The answer is that "control" here means control at shareholder level, the ability to pass an ordinary resolution in general meeting. Directors do not "control" a company, in the relevant sense, unless they control the company at that level.[26]

It follows that a charitable company is normally close if its directors

25 Table A para 70.

26 *Steele v EVC International* 69 TC 88 at p.127.

constitute all or a majority of the members of the company.[27]

The CT Manual para 60420 gives some examples:[28]

> The examples refer to companies having shares that are not dealt in or quoted on a stock exchange.
>
> ***Example 1***
> Company X has 1,000 issued shares of £1 held as below.
>
> | | |
> |---|---:|
> | Trustees of A's settlement | 449 |
> | Mrs A (settlor) | 60 |
> | Ten other shareholders | 491 |
> | Total issued ordinary shares | 1,000 |
>
> The ten shareholders are not associated with each other or with A or Mrs A and no one of them holds more than 50 shares.
> The trustees of A's settlement are associates of Mrs A by virtue of Section 417(3)(b) ICTA 1988, and their rights and powers may be attributed to Mrs A who therefore controls the company.
> Company X is therefore a close company.

This is correct, but it is not necessary to rely on the associates rule. The company would be close even if Mrs A were not the settlor since it is under the control of two (fewer than five) persons. The Manual continues:

> ***Example 2***
> The £1 issued shares in a trading company are owned as follows.
> **Ordinary shares**
>
> | | |
> |---|---:|
> | Directors | |
> | A | 4 |
> | B (cousin of A) | 4 |
> | Others | |
> | 12 individuals equally, none of whom is a nominee associate, etc, of any other | |

27 For example, an Oxford college (a body corporate) may be a close company, since:
(1) Its fellows may be "participators", if they possess voting rights in the body corporate.
(2) Its fellows manage the business of the body corporate, so they are (in principle) "directors".
(3) Its fellows control the body corporate, at shareholder level (or more accurately, at corporate member level).
It appears that HMRC do not take this point in practice.

28 In these examples I omit internal Manual cross-references and alter the formatting for increased clarity.

shareholder	4,992
Total issued ordinary shares	5,000
5% preference shares	
A (see above)	5,000
Total nominal and issued capital	10,000

There are no loan creditors ranking as participators or members.
The company is a close company because A possesses more than half the issued capital.

Example 3
The issued ordinary shares in a trading company carry one vote each but the 'A' ordinary shares do not confer voting rights. The shareholders are as below.

	Ordinary	'A' ordinary
A	280	
Wife of A	100	
B (brother of A)	10	
Trustees of A's settlement	40	
Company X (controlled by A)	80	
	510	
Mrs C (daughter of B)	20	
10 other equal holdings	470	500
Total issued shares	1,000	500

The shares carry equal rights to dividend. A's wife has made a loan of £20,000 to the company at 5% interest. There is no share premium account or other comparable account.[29]
The associates of A are:

1. his wife and his brother: Section 417(3)(a) and (4) ICTA 1988, and
2. the trustees of A's settlement: Section 417(3)(b) ICTA 1988.

The rights and powers attributable to A are:

a. the rights and powers of his associates: Section 416(6) ICTA 1988, and
b. the rights and powers of Company X: Section 416(6) ICTA 1988.

As a total of 510 votes are thus possessed by A or attributable to him, the company is a close company controlled by one person.

This is correct, but it is not necessary to rely on the associates rule. The company would be close even if none of the shareholders were associates,

29 A's wife's loan is wholly irrelevant and it is difficult to see why the example mentions it.

since it is under the control of five participators.[30]

Example 4

The authorised and issued share capital of Company X is £1,000 in the form of 1,000 ordinary shares of £1 each, held as below.

A	200
B	100
C	50
D	50
E	40
Company Y	99
Other shareholders	461
Total issued ordinary shares	1000

A, B and C are directors.

The issued capital of Company Y, is £100 in the form of 100 ordinary shares of £1 each, held by:

F (son of E)	60
G	40
Total issued shares	100

The shareholders in Company X, other than Company Y, are all individuals and none are related or otherwise associated. No 'other shareholder' holds more than 50 shares.

Control - the rights in the shares held by Company Y in Company X may be attributed to F who controls that company: Section 416(6) ICTA 1988.

F is an associate of E but the rights attributed to F cannot be further attributed to E: Section 416(6) ICTA 1988.

No group of five participators or fewer can control Company X, nor do the director/participators control, and nor would the winding up test be of assistance here.

Company X is not a close company.

Example 5

The facts are the same as in Example 4 except that F is the holder of one share in Company X.

Control rights can be attributed to F as below.

---

30 The text continues:

> "Alternatively control by holding the greater part of the issued share capital, (Section 416(2)(a) ICTA 1988, - any eight of the other equal holdings will control the company by holding the greater part of the issued share capital."

I do not understand this comment at all. Perhaps the text of the example is corrupt.

Shares held in own right	1
Shares held by E (an associate)	40
Shares held by Company Y (controlled by F)	99
	140

Thus A, B, C, D and F hold (or have attributed to them) the rights in 540 shares and control the company.
Company X is a close company.

Examples 4 and 5 neatly illustrate the arbitrary nature of the rules. At the margin, there is obviously some scope for tax planning.

Example 6
Company X has authorised capital of £5,000 in £1 ordinary shares of which £3,000 is issued as below.

A	150
B	150
C	150
D	250
E	250
F	250
20 other shareholders (no one holder having over 100 shares)	1800
Total issued ordinary shares	3000

The 20 other shareholders are individuals and none of the shareholders is an associate of any other. A, B and C are the directors. They each enter into a service agreement providing that they are to remain directors[31] for five years from 1 January 1992, and that on 31 December 1996, they shall each have the right to purchase 500 £1 shares in the company at par.
Control - A, B and C each exercises or is entitled to acquire rights in 650 shares: Section 416(2)(a) ICTA 1988 and Section 416(4) ICTA 1988.
Thus A, B, C, D and E (or A, B, C, D and F, or A, B, C, E and F) together constitute a group which is ‘able to exercise or is entitled to acquire, control’ of the company (with 2,450 shares out of 4,500, i.e. the 3,000 issued plus the 1,500 to be issued to the directors).
The company is a close company from 1 January 1992.

Example 7
The authorised and issued capital of an investment company is £33,000 and is owned equally by eleven individuals who are not associated. The loan creditors are:

31 The right to remain directors is irrelevant to the tax analysis.

A (director and shareholder)	£35,000
B (not a shareholder)	£13,500

Neither A nor B is a bank. B is not an associate of a director.
In a winding up, the value of the net assets distributable among members, including loan creditors, would be £120,000 as below.

Deposits with local authorities		£30,000
Market value of quoted investments (representing the remainder of the assets)		£110,000
		£140,000
Deduct sundry creditors		
Management expenses	£300	
Bank overdraft	£19,700	£20,000
Value of net assets		£120,000

Control - the company cannot be shown to be controlled by five or fewer participators under Section 416(2)(a) or (b) ICTA 1988. In a liquidation, the assets would, however, be distributed as below.

A as loan creditor	£35,000
B loan creditor	£13,500
Shareholders (£6,500 each)	£71,500
Value of net assets	£120,000

More than half of this sum would be received by three persons, that is:

A (£35,000 plus £6,500)	£41,500
B	£13,500
Any shareholder other than A	£6,500
Distribution to three persons	£61,500

The company is therefore a close company by reference to Section 416(2)(c) ICTA 1988 because the inclusion of loan creditors as participators shows that it is controlled by three participators.

63.17 The winding-up test

Section 414(2) ICTA provides for a case where the participators have rights which do not confer control:

> Subject to section 415 and subsection (5) below, a company resident in the UK (but not falling within subsection (1)(b) above) is also a close company if five or fewer participators, or participators who are directors,

together possess or are entitled to acquire—

(a) such rights as would, in the event of the winding-up of the company ("the relevant company") on the basis set out in subsection (2A) below, entitle them to receive the greater part of the assets of the relevant company which would then be available for distribution among the participators, or

(b) such rights as would in that event so entitle them if any rights which any of them or any other person has as a loan creditor (in relation to the relevant company or any other company) were disregarded.

The CT Manual provides:

60320. Rights in a winding-up

The tests so far considered in determining whether a company is a close company have depended on the question of control. With effect from 1 April 1989 there is a further test, in which control is irrelevant, based on rights in a winding-up. It is in Section 414(2) to (2D) ICTA 1988 and provides that a company ('the relevant company') is close if five or fewer participators, or participators who are directors, together possess or are entitled to acquire such rights as would, in the event of the winding-up of the company, entitle them to receive the greater part of the company's assets then available for distribution among the participators. By reason of Section 416(6) ICTA 1988 there is attributed to any participator all the rights of his associates.

This test is applied first on the basis that loan creditors are included as participators and then on the basis that they are disregarded. The company is close if it satisfies the test on either basis.

Section 414(2A) ICTA sets out the basis of the notional winding-up:

In the notional winding-up of the relevant company, the part of the assets available for distribution among the participators which any person is entitled to receive is the aggregate of—

(a) any part of those assets which he would be entitled to receive in the event of the winding-up of the company, and

(b) any part of those assets which he would be entitled to receive if—

(i) any other company which is a participator in the relevant company[32] and is entitled to receive any assets in the notional winding-up were also wound up on the basis set out in this subsection, and

(ii) the part of the assets of the relevant company to which the other company is entitled were distributed among the participators in the other company in proportion to their respective entitlement to the assets of the other company available for distribution among the participators.

Section 414(2C)(2D) ICTA are supplemental provisions:

> (2C) In ascertaining under subsection (2) above whether five or fewer participators, or participators who are directors, together possess or are entitled to acquire rights such as are mentioned in paragraph (a) or (b) of that subsection—
>
> (a) a person shall be treated as a participator in or director of the relevant company if he is a participator in or director of any other company which would be entitled to receive assets in the notional winding-up of the relevant company on the basis set out in subsection (2A) above, and
>
> (b) except in the application of subsection (2A) above, no account shall be taken of a participator which is a company unless the company possesses or is entitled to acquire the rights in a fiduciary or representative capacity.
>
> (2D) Subsections (4) to (6) of section 416 apply for the purposes of subsections (2) and (2A) above as they apply for the purposes of subsection (2) of that section.

CT Manual para 60320 provides:

> If in the course of the deemed winding-up of the relevant company assets would be received by a participator which is a company, we proceed on the basis that the corporate participator is itself wound-up and that the assets it received from the winding-up of the relevant company are distributed to its own participators in proportion to their

---

32 Section 414(2B) ICTA defines "relevant company":

> "In the application of subsection (2A) above to the notional winding-up of the other company and to any further notional winding-up required by paragraph (b) of that subsection (or by any further application of that paragraph), references to 'the relevant company' shall have effect as references to the company concerned."

respective entitlement to the assets of that corporate participator. If in the course of that deemed winding-up assets would be received by a further company the process is repeated. The process continues to be repeated until all of the assets of the relevant company are distributed to individuals (with the exception referred to below). The effect is that we ‘look through’ all participators which are companies.

The exception to this looking through is any company whose rights are possessed purely in a fiduciary or representative capacity. These stand with the individual participators in determining whether five or fewer participators would be entitled to receive the greater part of the assets available for distribution.

For the purposes of this test, then, the assets of the relevant company which would be distributed to any participator are the sum of what he would receive directly from the winding-up of that company plus what he would receive indirectly through the winding-up of participators which are companies.

For the purposes of this provision a person is treated as a participator in the relevant company if he is a participator in any company itself entitled to receive assets, directly or indirectly, in the winding-up of the relevant company.

63.18 Exceptions

63.18.1 *Non-resident company*

Section 414(1) ICTA sets out some exceptions to the general rule:

> ... except that the expression [close company] does not apply—
> (a) to a company not resident in the UK;

63.18.2 *Industrial and provident society or building society*

Section 414(1)(b) ICTA provides:

> ... except that the expression [close company] does not apply—
> (b) to a registered industrial and provident society within the meaning of section 486(12) or to a building society;

63.18.3 *Company controlled by the Crown*

Section 414(1)(c) ICTA provides:

... except that the expression [close company] does not apply—

(c) to a company controlled by or on behalf of the Crown, and not otherwise a close company;

Section 414(4) ICTA explains this:

For the purposes of this section—

(a) a company is to be treated as controlled by or on behalf of the Crown if, but only if, it is under the control of the Crown or of persons acting on behalf of the Crown, independently of any other person, and

(b) where a company is so controlled, it shall not be treated as being otherwise a close company unless it can be treated as a close company as being under the control of persons acting independently of the Crown.

The CT Manual provides:

60270. Control: By the Crown

A company is to be treated as controlled by or on behalf of the Crown (and therefore not a close company) if, and only if, it is by any of the control tests under the control of the Crown or of persons acting on behalf of the Crown, independently of any other person. If, however, it can be shown that under some other control test:

- five or fewer participators, or
- participators who are directors,

control the company and those participators (or director/participators) act independently of the Crown, the company is a close company.

The Crown for this purpose includes any Minister, Government Department or other person acting on behalf of the Crown.

60280. Control: Overseas governments and local authorities

A company should not be treated as a close company if the only persons who can be taken to have control of that company are any of the following:

- Overseas governments.
- The Crown Agents for Overseas Governments and Administrations.
- Local authorities or local authority associations exempt from tax under Section 519 ICTA 1988 (see CTM40850 onwards).

Nor should a company be treated as a close company if the only persons who can be taken to have control of that company are any of the above together with:

- a company or companies resident in the UK which are not close, or

- an overseas company or companies which, if resident in the UK, would not be close.

63.18.4 *Control by open company*

Section 414(1)(d) ICTA provides:

> ... except that the expression [close company] does not apply—
> (d) to a company falling within section 415 or subsection (5) below.

This takes us to s.414(5) ICTA which sets out two important exceptions. The first exception concern companies controlled by open (i.e. non-close) companies:

> A company is not to be treated as a close company—
> (a) if—
> (i) it is controlled by a company which is not a close[33] company, or by two or more companies none of which is a close company; and
> (ii) it cannot be treated as a close company except by taking as one of the five or fewer participators requisite for its being so treated a company which is not a close company ...
> (6) References in subsection (5) above to a close company shall be treated as applying to any company which, if resident in the UK, would be a close company.

The CT Manual provides:

> **60290. Control: By another company**
> A company is not to be treated as a close company where:
> - the company is controlled ... by an open company, or by two or more open companies, and
> - it cannot be treated as a close company ... except by including an open company in the group of five or fewer participators.
>
> A company is also not to be treated as a close company where:
> - the company can only be shown to be close under the control test in

[33] Section 414(6) ICTA provides:
"References in subsection (5) above to a close company shall be treated as applying to any company which, if resident in the UK, would be a close company."

Section 416(2)(c) ICTA 1988 (entitlement to receive the greater part of the assets in a winding-up, etc), and

- the company would not be close under the control test if the reference to 'participators' in Section 416(2)(c) excluded loan creditors who are open companies.

Where, in considering the above, you have to take into account a company not resident in the UK, the non-resident company is to be treated as a close company if, were it resident in the UK, it would be such a company.

The CT Manual para 60420 provides two simple examples:

Example 8

The issued ordinary capital of a trading company (other issued capital having no voting rights) is held as below.

Company A (not a close company)	280
Company B (a close company)	270
Company C (not a close company)	230
D (director)	40
E (director)	30
F (an individual)	30
20 others	120
Total issued ordinary shares	1,000

Control – the requirements of Section 414(5)(a)(i) ICTA 1988 are regarded as satisfied because, upon one combination of shareholdings, control is in the hands of Company A and Company C, even though by other combinations a controlling group which includes only one of those companies may be established. The company is not a close company if the requirements of Section 414(5)(a)(ii) ICTA 1988 are also satisfied, that is, if none of the control tests enables control by five or fewer participators to be established without including a non-close company among those participators, and the company is not controlled by its directors and cannot be shown to be close on the [or][34] winding up test without including a non-close company among the five or fewer participators (see, however, Example 9 below).

[34] This word is in the original but seems to be a typographical error.

Example 9

The ordinary shares are held as in Example 8. G, an individual, holds redeemable loan stock and would receive in a winding-up more than half of the assets available for distribution among the participators.

Control - as G is in control of the company by reference to Section 416(2)(c) ICTA 1988, the requirements of Section 414(5)(b) ICTA 1988 are not met and, irrespective of the control by open companies, the company is a close company.

63.18.5 *Pension funds*

Section 414(7) ICTA provides:

> If shares in any company ("the first company") are held on trust for a registered pension scheme, then, unless the scheme is established wholly or mainly for the benefit of persons who are, or are dependants of, directors or employees or past directors or employees of—
> (a) the first company; or
> (b) an associated company of the first company; or
> (c) a company which is under the control of any director or associate of a director of the first company or of two or more persons each of whom is such a director or associate; or
> (d) a close company;
>
> the persons holding the shares shall, for the purposes of subsection (5) above, be deemed to be the beneficial owners of the shares and, in that capacity, to be a company which is not a close company.

The CT Manual para 60290 summarises s.414(7) and provides:

> The broad effect of the above conditions is that the fund or scheme must be one established for the benefit of employees, etc, of an unrelated company which is not close. A joint fund for the benefit of employees of two or more companies is not disqualified if the majority of the beneficiaries are or were employees of qualifying companies or are dependants of such employees.

63.18.6 *Company with non-close loan creditors*

The second exception concerns non-close loan creditors. Section 414(1)(d) ICTA provides:

> ... except that the expression [close company] does not apply—
>
> (d) to a company falling within section 415 or subsection (5) below.

This takes us to s.414(5)(b) ICTA which provides:

> A company is not to be treated as a close company ...
>
> (b) [i] if it cannot be treated as a close company except by virtue of paragraph (a) of subsection (2) above or paragraph (c) of section 416(2) and
>
> [ii] it would not be a close company if the references in those paragraphs to participators did not include loan creditors who are companies other than close companies.

The CT Manual provides:

> **60300. Open company loan creditor**
>
> A company is not to be treated as a close company if:
>
> i) it is only close by virtue of the control test in Section 416(2)(c) ICTA 1988 (see CTM60220) or the 'winding-up' test in Section 414(2)(a) ICTA 1988 (see CTM60320), and
>
> ii) it would not be close if, for the purposes of those tests, open companies were not regarded as participators in respect of their interests in the company as loan creditors.
>
> In arriving at the amount available for distribution among the participators, any amount due to an open company as a loan creditor (including any amount due to it as a holder of loan capital) may be disregarded if the result is that the company ceases to be close (Section 414(5)(b) ICTA 1988).
>
> If the open company loan creditor also holds shares in the company, it will remain a participator in respect of that holding and any amount which would be distributed to it in respect of those shares should be taken into account for the purposes of Section 416(2)(c) and Section 414(2)(a).

63.19 Quoted company exemption

Section 415(1) ICTA provides:

> Subject to the following provisions of this section, a company is not to be treated as being at any time a close company if—

(a) shares[35] in the company carrying not less than 35 per cent of the voting power in the company (and not being shares entitled to a fixed rate of dividend, whether with or without a further right to participate in profits) have been allotted unconditionally to, or acquired unconditionally by, and are at that time beneficially held by, the public, and

(b) any such shares have within the preceding 12 months been the subject of dealings on a recognised stock exchange, and the shares have within those 12 months been listed on a recognised stock exchange.[36]

63.19.1 *"Held by the public"*

Section 415 ICTA provides:

> (3) For the purposes of subsection (1) above shares in a company shall be deemed to be beneficially held by the public if, and only if, they—
> (a) fall within subsection (4) below, and
> (b) are not within the exceptions in subsection (5) below,
> and a corresponding construction shall be given to the reference to shares which have been allotted unconditionally to, or acquired unconditionally by, the public.
> (4) Shares shall fall within this subsection (as being beneficially held by the public)—
> (a) if beneficially held by a company resident in the UK which is not a close company, or by a company not so resident which would not be a close company if it were so resident, or
> (b) if held on trust for a registered pension scheme, or
> (c) if they are not comprised in a principal member's holding.
> (5) Shares shall not be deemed to be held by the public if they are held—
> (a) by any director or associate of a director of the company, or
> (b) by any company which is under the control of any such director or associate, or of two or more persons each of whom is such a director or associate, or
> (c) by any associated company[37] of the company, or

---

35 Section 415(8) ICTA provides:
"In this section "shares" include stock."

36 The HMRC website has a list of recognised stock exchanges.

37 Section 416(1) ICTA provides the definition of associated company:
For the purposes of this Part, a company is to be treated as another's "associated company" at a given time if, at that time or at any other time within one year

(d) as part of any fund the capital or income of which is applicable or applied wholly or mainly for the benefit of, or of the dependants of, the employees or directors, or past employees or directors, of the company, or of any company within paragraph (b) or (c) above.

References in this subsection to shares held by any person include references to any shares the rights or powers attached to which could, for the purposes of section 416, be attributed to that person under subsection (5) of that section.

The CT Manual para 60310 provides:

> Where a company in [s.415(5)(b)(c)] above loses its beneficial interest in the shares, etc, on commencement of winding-up (see CTM36125) you should not normally accept that a company which was close before the commencement of that winding-up, thereby ceases to be close. ...
> 2. Shares beneficially held by an authorised unit trust (see CTM48200 onwards) are to be regarded as beneficially held by a company which is not a close company unless five or fewer persons hold more than half of the units issued by the trust. In determining the number of units held by a person, there should be attributed to him or her any units held by his or her associates (see CTM60150) or by his or her nominees or by any company (or companies) of which he/she has, or he/she and his associates have, control.

63.19.2 *Exception to quoted company exemption*

Section 415(2) ICTA provides:

> Subsection (1) above shall not apply to a company at any time when the total percentage of the voting power in the company possessed by all the company's principal members exceeds 85 per cent.

Section 415(6)(7) ICTA defines "principal members":

> (6) For the purposes of this section—
> (a) a person is a principal member of a company if he possesses a percentage of the voting power in the company of more than 5

previously, one of the two has control of the other, or both are under the control of the same person or persons.

per cent and, where there are more than five such persons, if he is one of the five persons who possess the greatest percentages or if, because two or more persons possess equal percentages of the voting power in the company, there are no such five persons, he is one of the six or more persons (so as to include those two or more who possess equal percentages) who possess the greatest percentages, and

(b) a principal member's holding consists of the shares which carry the voting power possessed by him.

(7) In arriving at the voting power which a person possesses, there shall be attributed to him any voting power which, for the purposes of section 416, would be attributed to him under subsection (5) or (6) of that section.

CHAPTER SIXTY FOUR

PERMANENT ESTABLISHMENT AND BRANCH/AGENCY

64.1 Why does permanent establishment matter?

It is not practical to set out a complete list of the significance of PE for tax, but the following are the most important.

In the absence of a PE, a non-resident company trading in the UK is subject to income tax on its income is not subject to CGT. If there is a PE, the company is subject to corporation tax under s.5 CTA:

> **5 Territorial scope of charge**
> (1) A UK resident company is chargeable to corporation tax on all its profits wherever arising.
> (2) A non-UK resident company is within the charge to corporation tax only if it carries on a trade in the UK through a permanent establishment in the UK.
> (3) A non-UK resident company which carries on a trade in the UK through a permanent establishment in the UK is chargeable to corporation tax on all its profits wherever arising that are chargeable profits as defined in section 19 (profits attributable to its permanent establishment in the UK)...

Section 19 CTA defines "chargeable profits":

> **19 Chargeable profits**
> (1) This section applies if a non-UK resident company carries on a trade in the UK through a permanent establishment in the UK.
> (2) The company's chargeable profits are its profits that are—
> (a) of a type mentioned in subsection (3), and
> (b) attributable to the permanent establishment in accordance with sections 20 to 32.

(3) The types of profits referred to in subsection (2)(a) are—
- (a) trading income arising directly or indirectly through or from the establishment,
- (b) income from property or rights used by, or held by or for, the establishment, and
- (c) chargeable gains falling within section 10B of TCGA 1992 (non-resident company with UK permanent establishment)—
  - (i) as a result of assets being used in or for the purposes of the trade carried on by the company through the establishment, or
  - (ii) as a result of assets being used or held for the purposes of the establishment or being acquired for use by or for the purposes of the establishment.

If there is a PE, chargeable gains come into charge under s.10B TCGA:

Non-resident company with UK permanent establishment
(1) Subject to any exceptions provided by this Act, the chargeable profits for the purposes of corporation tax of a company not resident in the UK but carrying on a trade in the UK through a permanent establishment there include chargeable gains accruing to the company on the disposal of—
- (a) assets situated in the UK and used in or for the purposes of the trade at or before the time the gain accrued, or
- (b) assets situated in the UK and used or held for the purposes of the permanent establishment at or before the time the gain accrued or acquired for use by or for the purposes of the permanent establishment.

(2) Subsection (1) does not apply unless the disposal is made at a time when the company is carrying on a trade in the UK through a permanent establishment there. ...

PE is relevant for double tax treaties. Last but not least, PE of a corporate trustee is relevant to trust residence.

If a non-resident *individual* or trustee is carrying on a trade in the UK, his UK tax position is not affected whether or not he is carrying on his trade through a PE but the PE may be relevant for a DTT and will normally constitute a branch or agency.

64.2 Meaning of "permanent establishment"

The definition(s) of PE need a book to itself.[1] The following is a brief introduction.

The term "permanent establishment" is used in different places with slightly different definitions. It is strictly necessary to distinguish between:

(1) "**UK law PE**" (which the INT Manual calls domestic law PE), defined in s.148 FA 2003.[2]
(2) "**OECD PE**" (which the INT Manual calls "treaty PE"), the definition in the OECD Model (I prefer the term "OECD PE" because different treaties have different definitions).

In practice the differences do not usually matter. HMRC agree. The INTM para 264050 provides:

> **Permanent establishment – Domestic law definition – Section 148 FA 2003** [March 2007]
> The definition of domestic law permanent establishment is at Section 148 FA 2003. This is similar to and has the same broad effect as the OECD model treaty article 5 definition of permanent establishment which is an important factor bearing in mind that treaty law takes precedence over domestic law. So it is unlikely that the application of a treaty that followed the model article 5 would cause any variance to the UK domestic charge to tax on a non-resident trading in the UK through a permanent establishment as defined under domestic law. Because of the similarities of wording and effect between PE under domestic law and under the OECD model treaty the guidance on interpretation of treaty PE at INTM266000 is understandably substantially applicable to domestic law PE as well.
> A lot of our interpretation of treaty PE is based on the Commentary to Article 5 of the OECD Model Treaty (INTM266030). Although the Commentary is not imported into UK domestic law the UK has contributed to and agreed the content except in specific instances where the UK has put on record either an observation or a reservation to a specific section of the Commentary. So, where the wording of the UK domestic law PE provisions are the same as those used in the OECD Model Treaty Article 5 then the commentary interpretation on those words will apply to those provisions and this guidance will contain

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1 See [2006] BTR at p.722.

2 Section 832(1) ICTA provides:

> "'permanent establishment', in relation to a company, has the meaning given by section 148 of the Finance Act 2003".

> cross-references into the guidance on treaty PE at INTM266000. If the Commentary interpretation of PE were to materially vary through periodic update or amendment the changes would have to be accepted by the UK Parliament before they could be taken to apply also to interpretation of UK domestic law PE.

There are two parts to the definition of PE: (a) fixed place of business and (b) agency PE. It is best to consider them separately.

64.2.1 *Commentary*

Since there is no significant difference between UK law PE and OECD PE, it is suggested that UK law should be amended to mirror the OECD definition exactly.

64.3 Fixed place of business

Section 148(1) FA 2003 provides:

> For the purposes of the Tax Acts a company has a permanent establishment in a territory if, and only if—
> (a) it has a fixed place of business there through which the business of the company is wholly or partly carried on ...

This does not apply to CGT but the same definition is applied in s.288(1) TCGA:

> In this Act, unless the context otherwise requires—
> "permanent establishment", in relation to a company, has the meaning given by section 148 of the Finance Act 2003;

The same definition in s. 989 ITA is otiose.

OECD Model is substantially the same as the UK law PE: article 5(1).

INTM para 264060 discusses UK law PE but that merely repeats and refers to the INTM discussion of OECD PE at 266050:

> **Fixed place of business permanent establishment** [November 2004]
> One of the two circumstances in which there can be a treaty permanent establishment is where there is a fixed place of business in one treaty partner's territory through which the business of an enterprise resident in the other treaty partner's territory is wholly or partly carried on – Model treaty Article 5(1).

This definition therefore contains the following essential features, all of which must be present:

a. there must be a geographic place of business, possibly premises or a site, although it can, in certain circumstances, be machinery or equipment.
b. the place of business must be fixed, that is, have a certain degree of permanence, and
c. the non-resident's business must be carried on through this fixed place of business, normally by the personnel of the enterprise.

It is possible for an enterprise to have more than one fixed place of business permanent establishment if it carries on business activities from more than one place for the necessary duration of time.

The INTM then goes on to consider these three conditions in more detail.

64.3.1 *Geographic condition*

INTM para 266060 provides:

Fixed place of business permanent establishment – Geographic condition [November 2004]

The words used in article 5(1) make it clear that there is a geographical condition within the fixed place of business treaty permanent establishment definition. There must be a distinct place of business being used for carrying on the business of the enterprise. The place could be premises, facilities, plant or machinery or even a site or installation. But equally the place of business could consist only of a space where premises are not necessarily required for the activities concerned. For example, a street vendor or market barrow enterprise could meet the geographic place condition where the business was carried out from appreciably one place whereas a French travelling salesman arriving in the UK and trading his French produce from door to door before returning to France would not meet the geographic condition and there would be no fixed place of business in the UK. For guidance on the scope for automated machinery to constitute a permanent establishment see INTM266090.

A place of business of one enterprise could be situated in the business premises of a second enterprise, including possibly an affiliated company, if some space were put at the disposal of the first enterprise. In considering whether a place of business is 'at the disposal of' an enterprise it makes no difference whether that enterprise's use is exclusive or shared, whether the enterprise owns, rents or even occupies a place illegally. As an example of when premises would be considered to be 'at the disposal of an enterprise', a travelling salesman would not be considered to have the premises of each of his prospective customers at his disposal, but a parent company using an office in the headquarters of a subsidiary company to oversee that subsidiary for a period would have had that office space at its disposal. Other examples can be found in the commentary to Article 5.

64.3.2 *Time condition*

INTM para 266070 provides:

Fixed place of business permanent establishment – Time condition – Degree of permanence of activities [November 2004]

The words used in article 5(1) make it clear that there is a time or degree of permanence condition inherent within the term 'fixed place of business' but it is not necessary that equipment or plant be physically fixed to the ground before it could constitute 'a fixed place of business'. There is no certain rule on the period that must pass before a place of business becomes 'fixed' and this can often depend on the nature of the activities. But it is immaterial how long an enterprise operates in another Country if it does not do so at a distinct place.

Since the place of business must be fixed, it also follows that a PE can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature. A place of business may, however, constitute a PE even though it exists, in practice, only for a very short period of time. It is sometimes difficult to determine whether this is the case. Whilst the practices of the different Member States of the OECD are not necessarily consistent in so far as time requirements are concerned, experience has shown that PEs have normally not been considered to exist in situations where a business has been carried on in a country through a place of business that was maintained for less than six months. Conversely practice shows that there were many cases where a PE has been considered to exist where the place of business was maintained for a period longer than six months. One exception to the six month yardstick has been where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a period of years). Another exception has been made where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have short duration because of its nature but since it is wholly carried out in that country, its connection with that country is stronger. Temporary interruptions of business activities do not cause a PE to cease to exist.

Where a place of business which was, at the outset, designed to be used for such a short period of time that it would not have constituted a PE but it is in fact maintained for such a period that it can no longer be considered as a temporary one, it becomes a fixed place of business and [as brought out at para 6.3 of the commentary to model treaty article 5(1)] can thus retrospectively be a PE. A place of business can also constitute a PE from its inception even though it existed, in practice, for a very short period of time, if as a consequence of special circumstances, e.g. death of the taxpayer, investment failure etc, it was prematurely terminated.

A PE begins to exist as soon as the enterprise commences to carry on business through a fixed place of business. A period of preparation, as distinct from the

real business activities, should not be treated as the business being carried out. The PE ceases to exist with the disposal of the fixed place of business or with the cessation of any activity through it.
A single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to the business. For example, the market stall mentioned already if it moved position within a market area. Similarly, a painter who undertook under a single contract to paint a multi-occupied estate would have a single place of business and the duration of his activities at that place would be gauged accordingly. But if the painter entered into individual contracts with unrelated occupants of premises on an estate his activities should be considered separately rather than as a coherent whole.

64.3.3 *Personnel condition*

INTM para 266080 provides:

Fixed place of business permanent establishment – Personnel condition [November 2004]
For a fixed place of business to constitute a PE the business of the enterprise must have been carried on through that place, i.e. persons working in the business must have worked from that place. Those persons could be employees, the entrepreneur or proprietor themselves or any other persons receiving instructions from the enterprise e.g. self-employed consultants.

It would follow that property let out is not a PE.

266090. Fixed place of business permanent establishment – Automated equipment [November 2004]
Where the business of an enterprise is carried out through automated machinery a PE may nevertheless exist if personnel are required to set up, operate, control or maintain such equipment. Whether or not gaming or vending machines and the like set up by a foreign enterprise in another State constitute a PE thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A PE does not exist if an enterprise merely sets up a machine and then leases it to another enterprise but it could if the first enterprise also operated and maintained the machine for its own account. This also applies if the machine is operated and maintained by an agent dependent (INTM266150) on the enterprise.
266091–266099.
266100.
Fixed place of business permanent establishment –
E-commerce/E-tailers/servers/internet trading [November 2004]
The development of e-commerce places a strain on the traditional definition of

> a PE in cases where the computer equipment is positioned in one territory whilst the enterprise has no personnel active in the business in that territory. The UK does not concur with other OECD Member States on whether a server of itself can constitute a fixed place of business permanent establishment. Accordingly the UK has made an observation to that effect in the commentary to the model treaty Article 5(1).
>
> In the UK, we take the view that a server either alone or together with web sites could not as such constitute a PE of a business that is conducting e-commerce through a web site on the server. We take that view regardless of whether the server is owned, rented or otherwise at the disposal of the business. This view was stated within Press Release 84/00 published on 11 April 2000.
>
> Other OECD Member States take the view that a server, as distinct from mere web sites (which cannot fulfil the geographic situs condition) could constitute a PE where the equipment is in fact fixed, i.e. that in fact it is not moved and is located at a specific location for a sufficient duration to indeed become fixed (INTM266050).

64.3.4 *Items specifically included as PE*

Section 148(2) FA 2003 provides a list of items which constitute a PE. The first seven are:

> For this purpose a "fixed place of business" includes (without prejudice to the generality of that expression)—
> (a) a place of management;
> (b) a branch;[3]
> (c) an office;
> (d) a factory;
> (e) a workshop;
> (f) an installation or structure for the exploration of natural resources;[4]
> (g) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources; ...

This is based on OECD Model Art 5(2). The INTM para 266110 sets out a précis of the article and continues:

> The wording of article 5(2)[5] make it clear that this is not an exhaustive list of the places that could be a permanent establishment.

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3 See 64.11.2 (Meaning of "branch").
4 This is not in the Model Treaty.
5 The text erroneously reads: 5(1).

Obviously. The INTM continues:

> Furthermore, it is clear that, to be a treaty permanent establishment, any of these types of places would also need to have the general attributes of a fixed place of business, i.e. the geographic, period of duration and personnel conditions.

The point was less clear to me and it is helpful to see it in writing.

64.3.5 *Building site, construction or installation project*

This is the eighth item in the list in s.148(2) FA 2003:

> For this purpose a "fixed place of business" includes (without prejudice to the generality of that expression)— ...
> (h) a building site or construction or installation project.[6]

The OECD Model moves this item into a paragraph of its own, and the wording is not quite the same. Article 5(2) provides:

> A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

This item, like the first seven in the list, is only a PE if it also meets the geographic time and personnel conditions.
The INTM para 266130 provides:

> **Fixed place of business permanent establishment – Building sites or construction or installation projects** [march 2007]
> The model treaty article 5 includes specific provisions in para 3 that a building site or construction or installation project constitutes a treaty permanent establishment only where it lasts more than 12 months. The commentary makes it clear that this includes also the construction of roads, bridges or canals, the renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals, the laying of pipes-lines and excavating and dredging. Additionally, the term 'installation project' is not restricted to an installation related to a construction project; it also includes the installation of new

6 Contrast the narrower OECD Model article 5(3) where the building site (etc) constitutes a PE only if it lasts more than 12 months.

equipment, such as a complex machine, in an existing building or outdoors.
The OECD member states have made this type of activity the subject of a specific rule because of the frequency with which it caused difficulties of interpretation. And, for clarity in the model treaty, 12 months duration has been taken to be a sufficient indication that the activity is a fixed place of business permanent establishment. Of course particular treaties may vary from the model in this respect and indeed different durations are included in many of the UK's treaties all of which can be referred to in full at DT2150 onwards. The UK domestic charging provisions in s.148(2)(h) FA 2003 define permanent establishment (see INTM264050) in a way that specifically includes all building sites or construction or installation projects without duration qualification. Although initially this may appear inconsistent you should remember that the treaty provisions will override the domestic legislation. In that way, any duration specified in any applicable treaty within which the site will become a permanent establishment will be the duration that applies.
If the non-resident is involved (directly or indirectly through subcontractors) in more than one site or project, each should be considered as a potential permanent establishment separately from the others. The 12 months or other duration test applies to each site or project. A site or project should be regarded as a single potential permanent establishment even if it is based on several contracts provided that it forms a coherent whole commercially and geographically. If it appears that a single site or project has been fragmented to avoid the appearance of being a PE the facts of the original tendering should be investigated.
A site or project exists from when the contractor begins work, including any preparatory work, in the country where the construction etc. is to be established. It continues to exist until the work is completed or permanently abandoned. Temporary discontinuation, seasonal or other temporary interruptions should be ignored.

64.4 Agency PE

Section 148 FA 2003 provides:

(1) For the purposes of the Tax Acts a company has a PE in a territory if, and only if ...
(b) an agent acting on behalf of the company has and habitually exercises there authority to do business on behalf of the company...

The OECD Model is slightly different. Article 5(5) provides:

[a] Notwithstanding the provisions of paras 1 and 2, where a person — other than an agent of an independent status to whom para 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an *authority to conclude contracts*

in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise,

[b] unless the activities of such person are limited to those mentioned in para 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.[7]

The ITH provides at para 851:

> Treaties following the example of the OECD Model are influenced by the civil law concept of agency. Para 5 of Article 5 of the Model deems an agent to be a permanent establishment if the agent has and habitually exercises an authority to conclude contracts in the name of the enterprise of the treaty partner state, unless the agent is an agent of independent status within para 6. There are two pointers here to civil law influence. One is 'contracts in the name of the enterprise', the other is 'agent of independent status'.

64.4.1 *Authority to conclude contracts in the name of the enterprise*

This point does not affect UK law PE. The ITH provides at para 852:

> **852. In the name of principal**
> The making of contracts in the name of the principal would be regarded by civil law countries as a characteristic of a dependent agent whereas contracts made in the agent's own name would be characteristic of independent status (though the wording of the Article does not preclude the possibility of independent status even if the contracts are in the name of the 'enterprise'). In our law, if the contracts are made on behalf of and with the authority of the principal the relationship of the agent to the principal is not affected by whether the contract is made in the name of the principal or in the agent's own name. So agents, who in all other respects would be dependent agents according to the OECD Model, could in our law make contracts in their own name. We would not wish such agents to be regarded as agents of independent status under a treaty and therefore resist the literal meaning of 'in the name of' and argue that the words should be interpreted as 'on behalf of', which is an acceptable translation of the words 'au nom de' which appear in the French version of the Model Convention. The commentary on Article 5 of the 1992 Model included a note of our view at para 45 and in 1994 a sentence was added to the commentary itself at para 32 confirming that this is now the accepted interpretation.

[7] See 64.7 (PE: preparatory and auxiliary).

The OECD Commentary provides:

> 32. Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents i.e. persons, whether employees or not, who are not independent agents falling under para 6. Such persons may be either individuals or companies. It would not have been in the interest of international economic relations to provide that the maintenance of any dependent person would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned. Therefore, para 5 proceeds on the basis that only persons having the authority to conclude contracts can lead to a permanent establishment for the enterprise maintaining them. In such a case the person has sufficient authority to bind the enterprise's participation in the business activities in the Stat concerned. The use of the term "permanent establishment" in this context presupposes, of course, that that person makes use of this authority repeatedly and not merely in isolated cases.
>
> 32.1 Also, the phrase "authority to conclude contracts in the name of the enterprise" does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise. Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions.
>
> 33. The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person ha authority to engage employees for the enterprise to assist that person's activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only. Moreover the authority has to be habitually exercised in the other State; whether or not this is the case should be determined on the basis of the commercial realities of the situation. A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in the State", even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation. The mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise. The fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on

behalf pf the enterprise. Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either.

33.1 The requirement that an agent must "habitually" exercise an authority to conclude contracts reflects the underlying principle in Article 5 that the presence which an enterprise maintains in a Contracting State should be more than merely transitory if the enterprise is to be regarded as maintaining a permanent establishment, and thus a taxable presence, in that State. The extent and frequency of activity necessary to conclude that the agent is "habitually exercising" contracting authority will depend on the nature of the contracts and the business of the principal. It is not possible to lay down a precise frequency test. Nonetheless, the same sorts of factors considered in para 6 would be relevant in making that determination.

The INTM discussion of OECD PE provides:

266140. Agent as permanent establishment [March 2007]

One of the ways in which a permanent establishment of a foreign enterprise may be brought into existence is where an agent, other than an agent of independent status, acting on behalf of the enterprise has, and habitually exercises, in a contracting state an authority to conclude contracts in the name of the enterprise – Model treaty Article 5(5). This is known as the 'deemed dependent agent permanent establishment' or 'agency permanent establishment'. This guidance covers the scope for there to be a UK PE of a non-UK enterprise or conversely the scope for there to be a PE of a UK enterprise in a foreign jurisdiction.

The commentary to article 5 (at para 35 in the July 2005 version), makes it clear that there is no need to consider, in respect of the same activities, whether a deemed independent agent PE exists if it is already clear that there is a fixed place of business PE.

Persons whose activities may create a PE for the enterprise are so-called dependent agents, i.e. persons, whether or not employees of the enterprise, who are not independent agents under article 5(6) of the model treaty (INTM266150). Such persons may be either individuals or companies and need not be residents of, nor have a place of business in, the State in which they act for the enterprise. Such treatment is to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned. Therefore, article 5(5) continues on the basis that only persons having the authority to conclude contracts can lead to a PE for the enterprise. In such a case the person has sufficient authority to bind the enterprise's participation in the business activity in the State concerned. The use of the term PE in this context presupposes, of course, that the person makes use of this authority repeatedly and not merely in isolated cases.

Also, the phrase 'authority to conclude contracts in the name of the enterprise' does not confine the application of the provisions to an agent who enters into

contracts literally in the name of the enterprise; the provisions apply equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise. Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions.
The authority to conclude contracts must cover contracts relating to operations that constitute the business proper of the enterprise; for example contracts for sale in the case of a merchanting business. It would be irrelevant, for instance, if the person only had authority to contract to say engage employees for the enterprise or some other resource outside of the main business transactions of the enterprise. A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise that authority 'in that State' even if the contract is signed by another person elsewhere. The level of an agent's actual authority in the business should be tested by reference to the commercial realities of the situation.
Where an agency PE exists on the basis of an agent carrying out another enterprise's business in another territory, the chargeable profits of that agency PE should include all of the agents activities for the enterprise, i.e. the chargeable profits are not limited to only those arising from the agent's conclusion of contracts for the enterprise.

64.5 Independent agent

Section 148(3) FA 2003 provides:

> A company is not regarded as having a PE in a territory by reason of the fact that it carries on business there through an agent of independent status acting in the ordinary course of his business.

The OECD Model is slightly differently worded, but the differences do not seem material. Article 5(6) provides:

> An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

64.5.1 *Broker and general commission agents*

The precise meanings of broker and general commission agent in the OECD PE definition do not matter too much since both terms are subsumed into "other agent of independent status". The INT Manual provides:

> **266150. Agent of independent status – Article 5(6)** [March 2007]
> The terms 'brokers' and 'general commission agents' are not defined in the model treaty or commentary and so for interpretation in the UK they take their ordinary UK meaning. In the UK both terms have been used historically in the 'machinery provisions' for imposing the UK tax obligations and liabilities upon the UK representative. So if interpretation (for UK taxation) of either term under a treaty should be problematic, see the guidance at INTM269050. ...

For completeness, "broker" is discussed at 37.4 (Meaning of "broker"). The ITH explains "general commission agent" in a passage too amusing to omit:

> **935. General commission agent**
> But a little difficulty arose from the 1925 Act and its later consolidation in 1952. Rather than write out the phrase broker or general commission agent the draftsman simply used the word broker and then added a note by way of postscript to say that a broker includes a general commission agent. This meant that the Courts had somehow to construe the words general commission agent as somebody with broker-like qualities. This complicated an already obscure situation. Although the words general commission agent appear in the legislation, nobody really knows what a general commission agent is and textbooks on agency make no reference to such a character; the expression is indeed used in our Double Taxation Agreements but it is not a term that our treaty partners are familiar with. They say it has no particular meaning for them and think that it is there because the British were rather insistent about it.
> **936. London Produce case**
> The one case to which we most often turn for guidance on who may or may not be a general commission agent is the London Produce case [*Fleming v London Produce Co Ltd* 44 TC 582]. The London Produce company acted as agents in importing meat from New Zealand and selling it for commission on the London market. 95 per cent of its business was carried out for one principal. It claimed to be a general

commission agent.
Megarry J enjoyed himself with the expression saying that he found it puzzling and unidentified. He wondered whether he might get at a meaning by looking at the words general, commission and agent separately and then adding the constituent parts together. He felt, however, that that was not a good idea because one could not arrive at the meaning of a particular high office by adding together the separate words lord, privy and seal. He came to the conclusion that a general commission agent must have broker-like qualities as it is included in the term 'broker' in the Section and that it is someone who holds himself out as being ready to work for clients generally. In his view Section 82(1) [TMA] (then Section 373(1) ITA 1952) could not be relevant if 'in substance what is done is that (the non-resident) carries on business within the UK through the medium of an agent who is virtually a sole agent running the entire business for him and merely sending him remittances on request'. London Produce lost the case.
The only other case is the earlier one of *Boyd v Stephen* [10 TC 698] (concerned with bacon) when Rowlatt rather summarily dismissed the suggestion that the agents were general commission agents on the grounds that they did much more than such an agent would normally do. What the words are probably getting at is somebody like an import commission agent. That is someone, probably more common in 1915, who, acting for a non-resident producer, will sell goods through a broker on the market in return for a commission. It is unlikely that the authors of the Section had in mind the smaller domestic markets such as meat and bacon.

64.5.2 *Independent status and ordinary course of business*

The requirements of independent status and "ordinary course of business" overlap slightly. The INTM comments on s.148(3) at para 264080:

> **Independent agents do not create a permanent establishment** [March 2007] [The INTM summarises s.148(3) and continues:] Whether an agent is of independent status is tested by reference to the legal, financial and commercial characteristics of the particular business relationship between the non-resident and the agent. If the relationship between them is the same as a relationship between independent businesses dealing with each other at arms length then the agent will be 'an independent agent'. For example, an agent who acted for other independent unconnected businesses on the same terms as those under which he acted for the non-resident could be an 'independent agent' and it would be clear that the agent had been acting in the ordinary course of his business if his activities were repeated for various unconnected customers. Dependent or

independent status does not turn on the shareholding relationship between principal and agent. The fact that an agent is a subsidiary company does not necessarily make it a dependent agent. However, a subsidiary company will constitute a domestic law agency PE of its parent company in the same way as any other agent of the parent company if independence by reference to the factors detailed in the guidance that follows cannot be demonstrated.

Whether an agent acts in the ordinary course of their own business is something that should be considered by reference to the behavioural facts as opposed to intentions not followed through in business performance. Matters relevant would include (but not necessarily be limited to) the number of unrelated principals that the agent acted for and the extent of the business activities customarily carried out by independent agents in the specific business sector concerned.

Assuming they did act in the ordinary course of their own business, in general, an agent would be independent and would not constitute an agency PE of the foreign enterprise for which it acts where it is independent of the principal enterprise both legally and economically. The perspective of application of this test is with relevance to the business conducted by the agent for the principal rather than, for example, any shareholding relationship between the principal and agent. Other relevant factors of independence may include:

- the extent of the obligations which the agent has vis-à-vis the non-resident;
- whether the agent is subject to detailed instructions or comprehensive control;
- whether the agent bears the entrepreneurial risk for the business that the agent carries out for the non-resident;
- the degree of reliance on the agent's special skill and knowledge by the principal in the business done, and
- Whether there is reference by the agent to the principal for approval of the manner in which the business is to be conducted.

There will undoubtedly be circumstances where, whether deliberately or not, the relationship between a non resident and a UK agent is obscure or even where the declared terms of that relationship are very different from the actual terms. In such cases there is no substitute for detailed enquiry into the relationship to see whether it falls within the category of dependent or independent agent.

ITH discusses the OECD Model wording at para 853:

Para 6 of Article 5 excludes brokers, general commission agents and any other agents of independent status from being treated as permanent establishments of an enterprise of the other state if they act for the enterprise in the ordinary course of their business. Brokers and general commission agents appear in our domestic law in the machinery provisions considered in the next chapter. The question, for us, is the degree, if any, to which 'any other agent of independent status' extends the category of exclusion beyond broker or general commission agent. The commentary on para 6 is clearly influenced by civil law concepts. One thing is clear – dependent or independent does not turn on the shareholding relationship between principal and agent. The fact that an agent is a subsidiary company does not alone make it a dependent agent and an agent unconnected with the enterprise may nevertheless be a dependent agent. Generally, however, this is a difficult area and the advice of International Division (Agency) should be sought if an agent who is not clearly a broker or general commission agent claims to be an agent of independent status.

INTM discusses the OECD Model wording. It partly duplicates the text of the discussion on s.148(3). The other parts provide:

266150. Agent of independent status – Article 5(6) [March 2007]
... The work done by an agent, where that work was all done for one non-resident client, is unlikely to be viewed as the conduct of his 'own business' but more likely that of the non-resident's business. An exception to that view might be where the concentration on one client was an unusual occurrence within a settled continuous trade involving several clients. ...
266151–266159.
266160. UK common law – Variance with civil law [March 2007]
The majority of European countries have civil law codes whereas the UK has a common law code. Any matters of interpretation of undefined terms used in article 5 or any other article of a treaty should be interpreted in the UK under UK law or at least common meaning. The civil law concept of agency is different from that under common law in that civil law will not usually regard the actions of an agent as though they were the actions of the principal. Civil law separates the relationship between the principal and the agent on the one hand and that between the agent and the third party (including a customer) on the other. Thus civil law countries do not, as the UK does, necessarily see the presence of the non-resident principal in the actions of the resident agent. In the UK, under common law, we interpret any actions carried out by an agent as having been performed for the principal and binding the principal in the same way as though they had carried out those actions themselves. For example, a contract arranged by an agent in the UK to deliver goods owned by a foreign principal to a customer would be treated for UK tax purposes as though the foreign principal themselves had contracted in the UK for the delivery. This is the case, regardless of whether the contract is written in the name of the principal or in the name of the agent (commentary to model treaty article 5(5), para 32.1 of July 2005 version).

64.6 Broker and Investment Manager exemptions

Para 1 Sch 26 FA 2003 provides:

Introduction
(1) This Schedule makes provision about transactions carried out on behalf of a company that is not resident in the UK (a "non-resident

> company"), in the course of that company's trade, by a person in the UK acting as—
> (a) a broker (para 2),
> (b) an investment manager (paras 3 to 5) ... [8]

Para 2(1) provides:

> In relation to a transaction carried out on behalf of a non-resident company, a broker is regarded as an agent of independent status acting in the ordinary course of his business if, and only if, the following conditions are met.

The conditions are those of the broker exemption. Similarly para 2(1) Sch 26 FA 2003 provides:

> In relation to an investment transaction carried out on behalf of a non-resident company by a person providing investment management services (an "investment manager"), the investment manager is regarded as an agent of independent status acting in the ordinary course of his business if and only if, the following conditions are met.

The conditions are those of the investment manager exemption.

If the company is carrying on a trade in the UK through a PE it is subject to corporation tax. SP 1/01 explains:

> 10. The Investment Manager Exemption legislation now only has relevance for corporation tax by providing greater clarity about what constitutes independence of investment managers in relation to the non-residents for which they act.

If a broker/IM qualifies for the broker/IM exemption the result is certainty:

(1) The non-resident company is not subject to CT because it has no domestic law PE.
(2) The non-resident company is not subject to IT because the broker/IM applies.

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[8] Para 1(c) concerns Lloyds and is not discussed here.

64.7 PE: preparatory and auxiliary activities

Section 148 FA 2003 provides:

> (4) A company is not regarded as having a permanent establishment in a territory by reason of the fact that—
> (a) a fixed place of business is maintained there for the purpose of carrying on activities for the company, or
> (b) an agent carries on activities there for and on behalf of the company,
> if, in relation to the business of the company as a whole, the activities carried on are only of a preparatory or auxiliary character.
> (5) For this purpose "activities of a preparatory or auxiliary character" include (without prejudice to the generality of that expression)—
> (a) the use of facilities for the purpose of storage, display or delivery of goods or merchandise belonging to the company;
> (b) the maintenance of a stock of goods or merchandise belonging to the company for the purpose of storage, display or delivery;
> (c) the maintenance of a stock of goods or merchandise belonging to the company for the purpose of processing by another person;
> (d) [i]purchasing goods or merchandise, or
> [ii] collecting information,
> for the company.

This is a slight rewrite of OECD Model but the differences in wording do not seem significant.

INTM para 264050 discusses this, but need not be set out as it only refers to (and repeats some material from) the INTM discussion of OECD PE at para 266120:

> **Fixed place of business permanent establishment – Activities specifically excluded from the definition of permanent establishment** [March 2007]
> Model treaty Article 5(4) lists certain activities that are not to be treated as permanent establishments even if they are carried on through a fixed place of business.

The Manual sets out a précis of the article and continues:

> In deciding whether or not a fixed place of business of a non-resident enterprise is used for activities of a preparatory or auxiliary nature, consider the following factors:
> a. Are the services it performs so remote from the actual realisation of profits by the enterprise that it would be difficult to allocate any part of the profit to the

> fixed place of business? If they are, then the fixed place of business will not be a permanent establishment. The benchmark to gauge the activities against are those of the trade as a whole entity. So, for example, if the UK activities are no different to the essence of the trade, e.g. the UK personnel collect market research information and the non-resident company's main trade is concerned with market research, then the activities in the UK would not be preparatory or auxiliary and there could be a permanent establishment in the UK.

An example is a research division of a trading or manufacturing company.

> b. Does the activity of the fixed place of business form an essential and significant part of the enterprise as a whole?

This sentence is from the OECD commentary but with respect it cannot be a correct or helpful test since all the activities specified as auxiliary are significant and some of them are essential.

> A fixed place of business whose general purpose is identical to the general purpose of the enterprise is not used for activities of a preparatory or auxiliary nature. Examples of this are fixed places of business used for the purpose of managing an enterprise, or where a fixed place of business is maintained to supply spare parts of machinery supplied by the enterprise to customers and to service such machinery.
> Note that the exclusion of activities of a preparatory or auxiliary nature from the definition of a permanent establishment only applies if these activities are solely for the non-resident enterprise. If the activities are performed not only for the enterprise but also for other enterprises, including other companies in the same group, then the fixed place of business will not be within the scope of the exclusion.

I find the last paragraph rather surprising though it is in the OECD Commentary. The OECD Commentary explains the reason for the exemption for collecting information:

> The reference to the collection of information in subpara d) is intended to include the case of the newspaper bureau which has no purpose other than to act as one of many "tentacles" of the parent body; to exempt such a bureau is to do no more than to extend the concept of "mere purchase".

64.8 Alternative finance arrangements

Section 148(5A) FA 2003 deals with alternative finance arrangements, and is not discussed here.

64.9 PE in old-style treaties

Article 2(1) of the UK/Jersey DTT provides a different definition of PE:

> The term "permanent establishment", when used with respect to an enterprise of one of the territories, means a branch, management or other fixed place of business, but does not include an agency unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of such enterprise or has a stock of merchandise from which he regularly fills orders on its behalf.

Guernsey and the Isle of Man are the same. This wording is based on s.17 FA 1930.

64.10 Why does branch/agency matter?

It is not possible to give a full list, but a branch/agency is important to an individual or trust for the following purposes:

(1) Tax may be collected from the branch/agency: see 33.1 (Collection of tax from UK representatives).
(2) The branch/agency may affect residence of individual trustees.
(3) The branch/agency gives rise to a liability to CGT.

Section 10 TCGA provides:

> **Non-resident with UK branch or agency**
> (1) Subject to any exceptions provided by this Act, a person shall be chargeable to capital gains tax in respect of chargeable gains accruing to him in a year of assessment in which he is not resident and not ordinarily resident in the UK but is carrying on a trade in the UK through a branch or agency, and shall be so chargeable on chargeable gains accruing on the disposal—
> (a) of assets situated in the UK and used in or for the purposes of the trade at or before the time when the capital gain accrued, or
> (b) of assets situated in the UK and used or held for the purposes of the branch or agency at or before that time, or assets acquired for use by or for the purposes of the branch or agency.

(2) Subsection (1) above does not apply unless the disposal is made at a time when the person is carrying on the trade in the UK through a branch or agency.

...

(5) This section shall apply as if references in subsections (1) and (2) above to a trade included references to a profession or vocation, but subsection (1) shall not apply in respect of chargeable gains accruing on the disposal of assets only used in or for the purposes of the profession or vocation before 14th March 1989 or only used or held for the purposes of the branch or agency before that date.

Lastly, the branch or agency is likely to be a PE, which is relevant for DTTs.

64.11 Meaning of "branch or agency"

64.11.1 *The statutory (non-)definition*

Section 10(6) TCGA provides:

> In this Act, unless the context otherwise requires,
> [a] "branch or agency" means any factorship, agency, receivership, branch or management, but
> [b] does not include any person within the exemptions in section 82 of the Management Act (general agents and brokers).

For the purposes of s.126 FA 1995, (UK representatives)[9] the term is likewise defined to mean "any factorship, agency, receivership, branch or management". The definition here does not include the restriction for general agents and brokers but these categories are taken out of the UK representative rules by other provisions.

The definition in s.10(6)[a] TCGA is completely useless, since it incorporates both words being defined, merely adding three further obscure or archaic terms which only seem to mean "agent" if they mean anything.[10] The INTM expresses the same point more tactfully:

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9 See 32.1 (Collection of tax from UK representatives).

10 The ITH explains at 842:

> "Factorship and receivership are forms of agency and so, usually, would 'management' be. The former two categories are found in the 1842 machinery

264090. Branch or agency – Statutory definition and practical recognition of a branch [March 2007]

...

There is a statutory definition of 'branch or agency' at Section 834(1) ICTA 1988 thus – "any factorship, agency, receivership, branch or management".[11] This is not particularly helpful so we must look for authority elsewhere including case law.

64.11.2 *Meaning of "branch"*

The ITH states at para 842:

> There is very little guidance on the meaning of 'branch'. We have been advised that the presence of a principal (in the case of a sole trader or partnership) or of employees on a more or less regular basis is likely to be an essential ingredient of a branch (though employees may also be agents).

The INTM discusses the meaning of branch at para 264090:

> Most people recognise a branch of a foreign business when they see one and the impression given to the public is helpful in deciding whether or not a branch exists. For example there are many branches of foreign banks that trade on the High Streets of many towns and cities in the UK. We know this, whether we bank with these branches or not, because the name of the foreign bank will be displayed across the shop front of the UK branch. The personnel running the UK branch will be carrying on the part of the foreign bank's trade that takes place in the UK. This amounts to the UK presence of the foreign bank's trade, i.e. a branch of its trade. That's an easy example in part because banks actually call themselves branches but it is worth stressing that whatever terminology

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> provisions, 'Management' was added in 1915 but has acquired more modern associations with the growth in the use of managers such as project managers and investment managers."

To be fair, it was not intended to be a definition as such, but simply as an abbreviation, to avoid the more cumbersome wording of, e.g. s.370 ITA 1952:

> "A non-resident person shall be assessable and chargeable in respect of any profits or gains arising, whether directly or indirectly, through or from any factorship, agency, receivership, branch or management, and shall be so assessable and chargeable in the name of the factor, agent, receiver, branch or manager."

11 [Author's Note.] The reference should be s.126(8) FA 1995. However, the definition there is the same, so it does not matter.

is used it is the activities carried on in the UK in relation to the foreign enterprise's overall business activities that are most relevant in deciding whether the UK activities are a branch of the foreign business.

64.11.3 *Meaning of "agency"*

The INTM continues:

> **264100. Agency – Common law concept** [November 2004]
> Practical experience will have introduced all of us to the idea of agency. We do not always deal directly with the principal because we sometimes deal with an intermediary or agent. The agent represents the principal in accordance with the terms of the agreement in place between them. That agreement may be oral or in writing and in legal terms is called the agent's authority. In representing the principal the agent may bring about a legal relationship between that principal and a third party. Typically the agent may conclude a contract on the principal's behalf with a third party – the common situation is that of the UK agent who makes a contract with an UK third party to sell some goods on behalf of a foreign principal.
> The English common law concept of agency is sometimes described by legal writers as the doctrine of identity. This conveys the concept that the agent is the alter ego of the principal. In the act of the agent we see directly the act of the principal; we regard what the agent does for the principal in just the same way as we would have regarded the same act if the principal had been here and had done it. If a contract for sale were made in the UK it would follow that a non-resident making a contract here through an agent would be trading here. Thus our domestic law concept of trading within the UK by non-residents and our common law concept of agency are intimately linked although the word agent appears nowhere in the income tax charging legislation. This contrasts with the legal position under civil law, which is detailed in the guidance at INTM266160.

64.11.4 *One concept or two?*

This approach treats the term "branch or agency" as two distinct concepts which need to be considered separately. It is considered this is the correct approach. In *Brackett v Chater*,[12] the Special Commissioners preferred to treat the term "branch or agency" as a single concept. They did not think it correct to consider separately whether there was a branch, and whether there was an agent. The difficulty with this approach is that it is far from clear what the single concept is, if it is distinct from the concepts of branch and of agency. (The statutory definition, as noted, does not help.) The Special Commissioners' solution is to ignore the wording altogether.[13] That is not the best approach to taxing statutes, even when dealing with 19th century fossils, and at a time when more emphasis is placed on a purposive approach. What can fairly be said is that the two concepts substantially overlap and a branch will generally constitute an agency. It may not be necessary to decide whether a person is a branch or an agent, as long as he is clearly one or the other.

The Special Commissioners continued:

> Mr. Brackett represents Drishane in this country and is in sole charge of the day to day conduct of the trading operations other than the formation of contracts. It is not straining language, in our opinion, to say that by entrusting those operations to his care Drishane has established at least a branch in this country. Alternatively Mr. Brackett can properly be described as the manager of those operations, because he personifies them. Nor can we accede to Mr. Brackett's argument that it is inappropriate to assess him as "agent for Drishane" because he does not have the status of an agent under the general law. The definition of "branch or agency" in s 118 Taxes Management Act adds that "branch or agent" shall be construed accordingly. We take that to mean that the term "agent" is used as the cognate noun to describe a person who represents a branch or agency. Mr. Brackett is undoubtedly the personification of the branch or management of Drishane's business in this country and is, in our opinion, properly assessed as "agent for Drishane" on the authority of s 79.

This conclusion does follow from the finding of fact in the first sentence, though the only support it received in the High Court was that the decision

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12 60 TC 134 & 639, at 646.

13 "It would, in our view, be perverse to hold that Drishane, which was effectively trading only in this country, through Mr. Brackett, is not within the charge to tax because of some semantic difficulty in fitting its arrangements with him to the wording of the definition of a branch or agency."

was one which the Special Commissioners were entitled to reach. The judge did agree that the word "agent" need not be an agent in the contract sense of a person empowered to enter into contracts on behalf of a principal. The judge continued:

> Wherever the contracts are made, I find it difficult to imagine how a non-resident company which carries on a trade with any degree of continuity in the UK can do so otherwise than through a "branch or agency" as defined in the Taxes Management Act 1970.

This is *obiter*, but given the breadth of the expression it seems right as a general rule but not as an absolute rule. The ITH at 846 takes the view that trading in the UK without a branch or agency is rare:

> Although such cases are rare it is possible for a non-resident individual to trade here other than through a branch or agency. A non-resident individual might come to this country for a short time so as not to become resident and carry on an itinerant trade. There would in such a situation be no branch and no agency. It is rather more difficult to imagine situations of that sort where the person concerned is a company. But notwithstanding the judge's comments in the Brackett case there may be cases where the UK activities of a non-resident company are divided between various persons in such a way that, although the activities amount to trading here, no one person or group of persons can be identified as a branch or agency through which the trade is carried on.

64.11.5 *Exception for general agents*

Section 10(6)[b] TCGA provides that branch or agency:

> does not include any person within the exemptions in section 82 of the Management Act (general agents and brokers).

The reference is to s.82 TMA 1970 which was repealed in 1995! This provided:

> Nothing in this Part of this Act shall render a non-resident person chargeable in the name of a broker or in the name of an agent not being an authorised person carrying on the regular agency of the non-resident person, in respect of profits or gains arising from sales or transactions carried out through such a broker or

> agent:
> Provided that where sales or transactions are carried out on behalf of a non-resident person through a broker in the ordinary course of his business as such and the broker
> (a) is a person carrying on bona fide the business of a broker in the UK, and
> (b) receives in respect of the business of the non-resident person which is transacted through him remuneration at a rate not less than that customary in the class of business in question,
> then, notwithstanding that the broker is a person who acts regularly for the non-resident person as such broker, the non-resident person shall not be chargeable in the name of that broker in respect of profits or gains arising from those sales or transactions.
> In this subsection, "broker" includes a general commission agent.

It is suggested that this should be taken as a reference to the three categories of exemption in the replacement legislation under which casual agents, brokers and investment managers may not be UK representatives.[14]

64.11.6 *Commentary: let's abolish branch/agency*

The FA 2003 replaced "branch or agency" with "PE" for the purposes of corporation tax. A press release explained the reason:

> The rules also alter our current terminology so that in future we tax "permanent establishments", (a term recognised internationally and used in our double taxation agreements), rather than "branches". The new rules are to be interpreted in accordance with OECD guidelines, to ensure that the UK is in accord with international consensus that reflects UK agreement. If internationally agreed changes are made in the future, then any new guidance can be included to assist in the interpretation of the UK rules, if the UK government decides it wishes to adopt them.[15]

This was a good reason to change corporation tax, and it is an equally good reason to bring IT and CGT into line. We do not need both concepts. The term PE should be extended to replace "branch or agency" altogether. This would be a worthwhile and trouble-free simplification in the law. It would probably make no difference whatsoever, because in practice the two terms come to much the same thing. The IT Self Assessment Manual agrees:

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14 See 32.5 (Agents not treated as UK representatives).
15 REV BN 25 para 8 (17 April 2002).

7.15 'Permanent establishment' is an internationally understood term … Branch or agency has the statutory definition at Section 126(8) FA 1995 of 'Any factorship, agency, receivership, branch or management' but it is interpreted on broadly equal lines to 'permanent establishment'. The reason for the relevance of the two terms is that the legislation applicable to companies only has been modernised to include the internationally understood term of 'permanent establishment', whilst the income tax legislative charging provisions, which apply to all persons (including companies) still use the term branch or agency.

APPENDIX ONE

TERMINOLOGY

App. 1 "United Kingdom" and related expressions

App. 1.1.1 *"United Kingdom"*

Interpretation Act 1978 Sch 1 provides that "United Kingdom" means Great Britain and Northern Ireland.

The Isle of Man and the Channel Islands do not form part of the UK.

App. 1.1.2 *"Great Britain"*

"Great Britain" means England, Wales and Scotland: s.1 Union with Scotland Act 1706 provides:

> That the two Kingdoms of England and Scotland shall upon the First day of May which shall be in the year One thousand seven hundred and seven and forever after be united into one Kingdom by the name of Great Britain …

App. 1.1.3 *"England"*

The definition of "England" is not usually an issue for tax. However, for completeness, para 5(a) Sch 2 Interpretation Act 1978 provides:

> in any Act passed before 1st April 1974, a reference to England includes Berwick upon Tweed and Monmouthshire and, in the case of an Act passed before the Welsh Language Act 1967, Wales.

App. 1.1.4 *Territorial sea*

"Territorial Sea" extends 12 nautical miles from shore, further defined in the United Nations Convention on the Law of the Sea.

Section 1013 ITA provides:

> The territorial sea of the UK is treated for the purposes of the Income Tax Acts as part of the UK.

Section 276 TCGA and s.830 ICTA make the same point for CGT and corporation tax. Section 172 SSCBA makes the same point for NIC.

There is no equivalent provision in the IHT legislation so the territorial sea is not part of the UK for IHT purposes (though this will not often be important).

App. 1.2 Meaning of "spouse"

The word "spouse" is used frequently in tax legislation so its meaning is important. The IHT Manual provides:

> **IHTM11032 - Spouse or civil partner exemption: definition of spouse and civil partner** [February 2006]
> The IHT legislation does not define 'spouse' or 'civil partner' so the general law applies. Consequently, the exemption applies to transfers between persons who are lawfully married to each other at the time of the transfer and to transfers between persons who are registered as civil partners of each other at the time of the transfer.
> Spouses include
> - persons who are validly married but separated
> - parties to a valid polygamous marriage.[1] The marriage confers the s.18 IHTA exemption on all the spouses' benefits which qualify under IHTA84/S18. Where the IHTA84/S18 (2) limit applies because of the spouses' foreign domicile (IHTM11033), the total exemption (including any similar lifetime exemptions) may not exceed the IHTA84/S18 (2) limit.
>
> The following are not spouses
> - persons who are living together but not lawfully married, however long the relationship may have lasted (England, Wales and Northern

1 See CG Manual 22070 [March 2006]:

> A polygamous marriage may be recognised as valid in UK law if it was valid in the country in which the ceremony occurred and, broadly, it was contracted by persons domiciled in that country.

Ireland)

- In Scotland the only form of irregular marriage now recognised by Scots law is that by cohabitation with habit and repute. Basically this arises where a man and woman cohabit together at bed and board as husband and wife and behave towards each other as such for a considerable length of time so as to produce a general belief in the society and neighbourhood in which they live, and among their friends and relatives that they are married. They are then presumed to be so in fact although it is impossible to state with any precision a place and a time when they exchanged the consent which is essential for marriage. If it is claimed that this common law style of marriage entitles the parties to the exemption under IHTA84/S.18(1) in either a death or lifetime situation you should refer the file to TG (IHTM1081).[2]
  (This text has been withheld because of exemptions in the Freedom of Information Act 2000)
- parties to a bigamous marriage
- persons who were formerly lawfully married but divorced before the date of death/transfer

The argument that discrimination between married and unmarried couples is in breach of article 14 ECHR (Prohibition of discrimination) has failed, though only narrowly.[3]

App. 1.3 Meaning of "civil partner"

Schedule 1 Interpretation Act 1978 provides:

> "Civil partnership" means a civil partnership which exists under or by virtue of the Civil Partnership Act 2004 (and any reference to a civil partner is to be read accordingly).

This takes us to s.1(1) Civil Partnership Act 2004 which provides:

> A civil partnership is a relationship between two people of the same sex

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2 [Author's note] Marriage by cohabitation with habit and repute was abolished by the Family Law (Scotland) Act 2005, but it remains for couples whose cohabitation began before commencement.

3 *Holland v IRC* [2003] STC (SCD) 43; *Burden v UK* [2007] STC 252.

("civil partners")—
(a) which is formed when they register as civil partners of each other—
  (i) in England or Wales (under Part 2),
  (ii) in Scotland (under Part 3),
  (iii) in Northern Ireland (under Part 4), or
  (iv) outside the United Kingdom under an Order in Council made under Chapter 1 of Part 5 (registration at British consulates etc. or by armed forces personnel), or
(b) which they are treated under Chapter 2 of Part 5 as having formed (at the time determined under that Chapter) by virtue of having registered an overseas relationship. ...

Thus there are two types of civil partnership: those made under UK law, and overseas relationships.

App. 1.3.1 *Overseas relationships treated as civil partnerships*

Section 212(1) CPA 2004 provides:

For the purposes of this Act an overseas relationship is a relationship which—
(a) is either a specified relationship or a relationship which meets the general conditions, and
(b) is registered (whether before or after the passing of this Act) with a responsible authority in a country or territory outside the United Kingdom ...

Thus there are two types of overseas relationships: specified ones, or those not specified which meet the general conditions.

Section 213 defines "specified relationships": this currently includes same sex relationships under the law of the following countries:

Belgium
Canada: Nova Scotia and Quebec
Denmark
Finland
France
Germany
Iceland
Netherlands

Norway
Sweden
USA: Vermont

Section 214 CPA 2004 explains the "general conditions":

The general conditions are that, under the relevant law—
(a) the relationship may not be entered into if either of the parties is already a party to a relationship of that kind or lawfully married,
(b) the relationship is of indeterminate duration, and
(c) the effect of entering into it is that the parties are—
  (i) treated as a couple either generally or for specified purposes, or
  (ii) treated as married.

I understand this will include:

- other Canadian jurisdictions (except Alberta);
- USA: Hawaii and California;
- Switzerland: Cantons of Geneve and Zurich.

App. 1.3.2 *Pre-existing Civil Partnerships under foreign law: transitional rules*

Section 215 CPA 2004 provides:

215 Overseas relationships treated as civil partnerships: the general rule
(1) Two people are to be treated as having formed a civil partnership as a result of having registered an overseas relationship if, under the relevant law, they—
  (a) had capacity to enter into the relationship, and
  (b) met all requirements necessary to ensure the formal validity of the relationship.
(2) Subject to subsection (3), the time when they are to be treated as having formed the civil partnership is the time when the overseas relationship is registered (under the relevant law) as having been entered into.
(3) If the overseas relationship is registered (under the relevant law) as having been entered into before this section comes into force, the

time when they are to be treated as having formed a civil partnership is the time when this section comes into force.

Civil partners with existing overseas relationships became civil partners in England law without doing anything more.

For most tax purposes, the position of civil partners is the same as spouses. It is clumsy to say "spouse or civil partner", or "marriage or civil partnership". So in this book (unless otherwise indicated) the word "spouse" includes civil partners; the word "marriage" includes civil partnerships; and widow/er includes a surviving civil partner.

In strict language (and in contexts other than tax, strict language will be the norm) these terms are not so widely construed, and "spouse" will not include civil partner, etc.

App. 1.4 Inheritance tax terminology

One can launch into income tax or CGT knowing nothing about the subject. IHT is extremely technical. A glossary for those unfamiliar with IHT is accessible on *www.hmrc.gov.uk/cto/glossary.htm*. I assume the reader is familiar with the following terms:

Term		**Definition**
Transfer of value	:	s.3(a) IHTA
Chargeable transfer	:	s.2 IHTA
Exempt transfer	:	Part II IHTA
PET	:	s.3A IHTA
Estate IP[4]	:	An interest in possession to which s.49 IHTA applies (interest arising before 22 March 2006, TSIs, IPDIs, disabled persons interests)
Non-estate IP	:	Any other interest in possession.

4 The terminology was suggested by Chris Jarman: see his IHT Alignment (Tolley, 2006) para 5.3 for a further useful discussion of IHT terminology. Others refer to recognised or qualifying IPs, but "estate IP" seems the clearest term, reminding the reader that the trust property is deemed under s.49 IHTA to be in the life tenant's estate.

APPENDIX TWO

BAKER AND GARLAND TRUST JURISDICTIONS

This list is published by HMRC.[1] The footnotes are my own.

Argentina	No Trust Law
Australia[2]	
New South Wales	Baker
Queensland	Baker
South Australia	Baker
Victoria	Baker
Western Australia	Baker
Bahamas	Baker
Barbados	Baker
Belgium	No Trust Law
Belize	Baker
Canada[3]	
British Columbia	Baker
Nova Scotia	Baker
Ontario	Baker
Saskatchewan	Baker
Quebec[4]	Garland
Cayman Islands	Baker
Denmark	Garland
Egypt	Baker
Estonia	Baker
Fiji	Baker
France[5]	No Trust Law
Ghana	Baker
Gibraltar	Baker
Guernsey	Baker
Guyana	Baker
Hong Kong	Baker
Hungary	Baker
India[6]	Garland
Ireland, Republic of[7]	Baker
Isle of Man	Baker
Italy[8]	No Trust Law
Japan	No Trust Law
Jersey[9]	Baker
Kenya	Baker
Latvia	Baker
Liechtenstein	Garland
Lithuania	Baker
Luxembourg	Baker
Malaysia	Baker
Malawi	Baker
Malta[10]	No Trust Law
Monaco	No Trust Law
Montserrat	Baker
Namibia	Garland
Netherlands	No Trust Law[11]
New Hebrides	Baker
New Zealand	Baker
Nigeria	Baker
Norway	Garland
St Helena	Baker
St Vincent	Baker
Singapore	Baker
South Africa[12]	Garland
South Yemen	Baker
Spain	No Trust Law
Sri Lanka	Baker
Sweden	Garland
Trinidad & Tobago	Baker
Uganda	Baker
USA[13]	
New York	Garland
Minnesota	Garland
Montana	Garland
North Dakota	Garland
South Dakota	Garland
Wisconsin	Garland
All other states[14]	Baker
Zambia	Baker
Zimbabwe	Garland

1 *www.hmrc.gov.uk/cnr/nr_trusts.htm#baker_garland_countries*.

2 The list omits Tasmania, Northern Territory and Australian Capital Territory. It is considered that these are *Baker* jurisdictions.

3 This seems correct: see *Minister of National Revenue* [1956] SCR 49 especially [1953] Ex CR 292 at 297, accessible *www.kessler.co.uk*. The list of Canadian jurisdictions omits Alberta, Manitoba, New Brunswick, Newfoundland and Labrador, Northwest Territories, Nunavat, Prince Edward Island and Yukon. It is suggested that these are the same as the other Canadian common law jurisdictions, i.e. *Baker* jurisdictions.

4 This seems well founded in Art. 1261 Code Civil Québec: "The trust patrimony, consisting of the property transferred to the trust, constitutes a patrimony by appropriation, autonomous and distinct from that of the settlor, trustee or beneficiary *and in which none of them has any real right*". See also "Trusts without Equity" George Gretton, ICLQ 49, No.3 (July 2000).

5 France was omitted (accidentally?) from the version of the list published 1 April 2008, but the comment in the earlier version of the list is printed here as it is correct.

6 *Duncan's Executors v Adamson* (1935) 14 ATC 22 so held. This seems soundly based on s.3 Indian Trusts Act 1882: "The 'beneficial interest' or 'interest' of the beneficiary is his right against the trustee as owner of the trust-property."

7 The list omits Northern Ireland: this is a *Baker* jurisdiction.

8 This is not correct: Italy does have a trust law.

9 Paul Matthews agrees: *Jersey Law of Trusts*, 3rd ed., para 1.21.

10 In fact Malta does not have a trust law.

11 This is not correct: The Netherlands does have a trust law.

12 Honoré agrees: *South African Law of Trusts*, 4th ed., 1991, para 349.

13 New York was (rather implausibly) found to be a *Garland* jurisdiction in *Garland v Archer-Shee* 15 TC 693. The finding of fact in *Garland* was also made in *Timpson's Executors v Yerbury* 20 TC 155 at p.157, and was accepted as common ground in *Astor v Perry* 19 TC 255. See "Taxing Foreign Income from Pitt to the Tax Law Rewrite – The Decline of the Remittance Basis", John Avery Jones in *Studies in the History of Tax Law*, Hart Publishing, 2004 p.46 accessible on *www.kessler.co.uk* for contrary views as to US law. Since foreign law is a question of fact, a court would not be bound by those decisions, but in practice they are not likely to be challenged.

14 This may not be correct for all the other states. In particular, Ohio and New Jersey have been found to be *Garland* jurisdictions. See *The Marchioness of Ormond v Brown* 17 TC 333 at p.341, *Kelly v Rogers* 19 TC 692 at p.696. But see the above footnote. In *Lawson v Rolfe* 46 TC 199 it was common ground that California was a *Baker* jurisdiction.

APPENDIX THREE

PRE-2008 MIXED FUND RULE

App 3.1 Remittance from mixture of capital and foreign income

In *Scottish Provident Institution v Allan* 4 TC 591, the taxpayer held offshore:

(1) capital which had been invested in secured loans in Australia; and
(2) interest from those loans, which qualified for the remittance basis, and which was therefore untaxed unless and until remitted.

A sum was remitted to the UK and the question was whether this sum was the untaxed income or the capital. The background was this:

(1) The income and capital had been paid into a single account (mixed).
(2) The remittances (from the Australian agents) had been accompanied by letters stating that the sums remitted represent repayments of the loans, i.e. capital. The loans had in some cases been repaid only very shortly before the remittance.
(3) The sum remitted (£200,000) was only a small proportion of the loans and interest received (each about £1.5m).

It was held that the remitted sum was the foreign income, not capital. The Lord Chancellor said:

> It is obvious that the mere nicknaming the sum received and ascribing to it, because it is so named, the character of capital and not of income, cannot defeat the right of the Crown to have the tax levied upon that which in substance and truth is [income] ...

Lord Davey:

> I must say that that is a draft upon my credulity, a strain upon my

> powers of belief, which they will not bear. I agree that the mere calling it capital for the purpose of the Inland Revenue Department will not make into capital that which is essentially and in truth ... the interest received on the securities.

Two points shine out:

(1) The description of the remittance as capital does not make the remittance capital if "in truth" it is income. This is obviously right, an application of the Shakespearean principle that "a rose by any other name ..." However, this principle does not address the more fundamental question of *how* the courts determine what is income and what is capital.
(2) The answer to this second question is that the courts look to the substance.

However, it is one thing to look for the substance, and another to find and identify it. Why, in substance, was the remittance from the income, not from the capital? The answer may be found in the speech of Lord Robertson: "The facts of the case must furnish the inference."
The following facts were relevant:

> [1] First of all there is the fact of remittance in two consecutive years ...
> [2] There is no suggestion that any exceptional reason required remittances of capital, in either year or in both.
> [3] On the other hand it is certain that the amount of invested capital left behind in the Colony, after these remittances, is larger than before; so that the capital is fully accounted for.
> [4] Well then, what is done with this so-called capital remitted? The answer is, exactly what would be done with profits.

[Paragraphing added]

This is explained by Lord Shand in argument:

> If it is capital you have brought back and distributed as bonus, you have been paying back capital, which I should think you have no authority to do.

This is why Lord Robertson concluded:

> The inference from these facts is that the moneys remitted were in fact profits, [i.e. income] ...

The Inspectors Manual paragraph 1566 gives the HMRC view:

> Where a person maintains abroad a fund (for example, a bank account) containing income assessable on the remittance basis, a capital lodgement to the fund is normally considered to lose its identity in the fund. A subsequent remittance from such a mixed fund, therefore, represents income up to the full extent of the income content of the fund (see *Scottish Provident Institution v Allan* 4 TC 409 and 4 TC 591, and especially the Lord Chancellor's remarks on 'mere nicknaming' at 4 TC 593). Only when the income content of the fund is exhausted will any balance remitted be regarded as capital. Where this is not accepted, the full facts of the case should be reported to Revenue Policy, International (Cases IV and V), Victory House.

The HMRC view over-simplifies the law as expounded in *SPI v Allan.* There is no rule that the remittance out of a mixed fund of income and capital is bound to be treated as income. Suppose a taxpayer remits a substantial amount, exceeding the income, and applies it to an investment in the UK, or on capital expenditure here, such as the purchase of a house. It is considered that the "substance" of the matter, applying Lord Robertson's approach, is that the remittance is one of capital. The position is even stronger if the taxpayer first uses an amount equal to the income of a mixed account on expenditure abroad of an income nature. It is understood that HMRC have accepted this view in practice.

It is also important to note that *SPI v Allan* was a case where the mixed fund was capital and income. The case can have no application where the mixed fund consists of:

(1) income and income; see below (Remittance from mixture of taxed and untaxed income; Remittance from mixture of untaxed income and income qualifying for DTT relief);
(2) capital and capital; see below (Remittances out of mixed capital funds).

App. 3.1.1 *Reconciling* SPI v Allan *and* Duke of Roxburghe

At first sight there is some tension between these two cases. In the first, "mere nicknaming" was contemptuously dismissed; in the second, it was the "legal right" of the Duchess to direct whether the remittance was from one part of a mixed fund or the other. The cases agree, however, that the matter is one of "substance". It is submitted that the cases can be reconciled in this way: in a marginal case, the description of the remittance given by the taxpayer may be decisive. Where the substance of the transaction shows that a remittance is one of income or capital, "mere nicknaming" will not alter the position.

App. 3.1.2 *Further authorities?*

The above are the only authorities in point. A similar question, once extensively litigated, is whether charges on income were paid from "profits brought into charge to income tax". It is suggested in *Roxburghe*[1] that this line of cases sheds some light on the remittance issues; I am inclined to think that such guidance is very limited, because this question is answered in an entirely different manner. Likewise case law on tracing is of no assistance here – that tracing approach was expressly rejected in *Roxburghe*.

App 3.2 Remittance from mixture of untaxed income and income qualifying for DTT relief

Suppose an individual holds in one mixed fund:

(1) income which is subject to foreign tax and qualifies for UK double tax relief; and
(2) untaxed foreign income taxable in full on the remittance basis.

It is considered that the *Roxburghe* approach applies. A remittance from this mixed fund should be regarded as made first of all out of the income which qualifies for UK double tax relief. However, it would be better practice:

(1) to pay the income qualifying for DTT relief into a separate account, and
(2) to remit funds from that account.

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1 I add for completeness that Lord Moncrieff (who was one of the judges in *Roxburghe*) repeated this view in *IRC v Ayr Town Council* 22 TC 381.

Then this issue does not arise and a remittance from the DTT account can easily be identified as qualifying for DTT relief.

App 3.3 Remittances out of mixed capital funds

Suppose an individual holds in one mixed fund:

(1) capital which does not represent any chargeable gain within the scope of CGT; and
(2) the proceeds of a disposal on which a chargeable gain accrued.

A remittance from this fund should for CGT purposes be treated as coming out of the tax free source first. It would be wise to adopt the narrower view of *Roxburghe,* so the taxpayer should direct the bank to make the remittance from the tax free capital, rather than the taxable capital.

App 3.4 Remittance from mixture of taxed and untaxed income

In *Duke of Roxburghe's Executors v IRC* 20 TC 711 a taxpayer received and held offshore:

(1) income subject to UK tax on an arising basis ("taxed income");[2] and
(2) foreign income which qualified for the remittance basis, and which was therefore untaxed unless and until remitted ("untaxed income").

These were wisely held in separate accounts in one bank and so a remittance out of the taxed income account would not have been taxable. The taxpayer correctly directed the bank to make a remittance to the UK out of her taxed income account. Unfortunately the bank made a remittance out of the wrong account, so the sum remitted could (largely) be traced to untaxed income!

The Commissioners applied a tracing principle. The sum remitted was traced to taxed income, as to part; but the balance was traced to untaxed income, and so there was a tax charge on this remitted amount. The Court of Session surprisingly reversed this decision, on two alternative grounds.

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2 Being foreign source income of a class of income not then qualifying for the remittance basis and so subject to UK income tax on an arising basis.

The first ground identified the sum remitted as taxed income because the taxpayer had *intended* the remittance to come out of taxed income:

> the Duchess was entitled to have the remittance debited against any fund belonging to her and under her control and that she did so effectually by the *instructions* to debit it against money not derived from the [untaxed] income.[3]

The second ground was that a remittance out of a bank account with taxed and untaxed income is necessarily to be treated as out of the taxed income. The intention of the taxpayer is irrelevant. This applies in every case unless very unusually[4] there is something in the substance (as opposed to book-keeping) to show the contrary. Lord Normand and Lord Fleming inclined to this view, without deciding it; Lord Moncrieff based his decision on this view.

HMRC accept the second view of the decision: the Inspectors Manual reads:

> **1568. Mixed fund/income assessable: Arising/remittance**
> Published: 2/87
> Where a person maintains abroad a mixed fund consisting partly of income assessable on the arising basis and partly of income assessable on the remittance basis, any remittances made to this country out of that fund may be regarded as made primarily out of the income assessable on the arising basis and only the balance out of income assessable on the remittance basis.

Although the taxpayer in *Roxburghe* kept the funds in two accounts at the bank, the result would have been the same if the taxed and untaxed

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3 Lord Normand at page 726 (emphasis added). This was also the view of Lord Fleming who expressed himself in similar words: "I base my decision ... on the ground that it was the legal right of the Duchess to make the appropriation against any particular fund belonging to herself, and that in law she made that appropriation when she directed the Bank making the remittance to charge it against her funds in their hands which had already borne British Income Tax." (p.732).

4 Lord Normand gives one example of the exceptional case: "For example, if the Duchess, in the present case, had enjoyed [taxed income] under the condition of applying a part of it to some expenditure or purpose in the United States, she might have been disabled from asserting that the whole of that income was used for remittance to the UK. Accounts made up on the footing that the whole of that income was available for remittance would then fall to be ignored or corrected."

income had been held in a single bank account. This was accepted without argument in *Walsh v Randall* 23 TC 55: see para. 3 of the Special Commissioners' decision, and it is accepted in this passage from the Inspectors Manual.

App 3.5 Remittance of gain or remittance of base cost?

Suppose a foreign domiciliary purchases a foreign asset for £1m; he sells it for £3m and realises a chargeable gain of £2m. If he remits the entire £3m proceeds, the entire £2m gain is charged to CGT. But what is the position if he remits only £1m and retains the balance abroad? There are four possibilities:
(1) The amount remitted is "in respect of" the gain and CGT is charged on £1m.
(2) The amount remitted is not "in respect of" the gain (it is in respect of the CGT base cost) and is not chargeable to CGT.
(3) A proportionate part of the amount remitted is in respect of the gain and CGT is charged on two-thirds of £1m.
(4) The individual has power to determine whether (or to what extent) the amount remitted is in respect of gain or base cost.

Inspectors Manual para.1567 published 9/95 provides:

> Where a capital remittance is made to the UK from a fund or account into which the proceeds of sale of assets situated outside the UK have been paid, the remittance will include a due proportion of any capital gains[5] arising from the disposal transactions. This is because, whilst the income content of any fund is a separate and distinguishable part of that fund, a capital gain is merely part of the whole proceeds of a disposal transaction that has no separate identifiable existence within those proceeds.

The last sentence is correct to say that a capital gain has no identifiable existence. I do not think it even exists as "part of the whole proceeds". It is not a separate or separable item of property existing at all. The gain is merely the result of a computation. The proceeds of a disposal represent the gain, but they do not constitute the gain, just as trading receipts do not

5 The italicised words are a paraphrase of the statutory test, which is not whether the amount remitted includes the gain, but whether it is in respect of the gain. Note how this rephrasing subtly bolsters the HMRC view.

constitute the profits of a trade. So it is considered that the HMRC view is correct.

POSTSCRIPT

The ICEAW Tax Faculty offer ten tax tenets.[6] The tax system should be:

1. **Statutory**: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. **Certain**: It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate.[7]

3. **Simple**:

4. **Easy to collect and to calculate**:

5. **Properly targeted**: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. **Constant**: Changes to the underlying rules should be kept to a minimum.

7. **Subject to proper consultation**:

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6 *www.icaew.co.uk/index.cfm?route=128518.*

7 According to the case law of the European Court of Justice:

> "the principle of legal certainty, which is part of the Community legal order, requires that Community legislation must be clear and precise and its application foreseeable by individuals. That requirement must be observed all the more strictly in the case of an act liable to have financial consequences and imposing obligations on individuals in order that those concerned may know precisely the extent of the obligations which it imposes on them."

Recital 2, Guidelines for the Quality of Drafting of Community Legislation (1999/C 73/01). The thought (significantly) can be traced (at least) to Montesquieu: The Spirit of the Laws, 1748, part 6, book 29 (the way to compose laws).

8. **Regularly reviewed**: If a tax rule is no longer relevant, then it should be repealed.

9. **Fair and reasonable**: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. **Competitive**: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

Readers are invited to speculate to what extent the UK authorities achieve, or even aspire to, the same goals.

All indexing is to paragraph number

All indexing is to paragraph number