TAXATION OF FOREIGN DOMICILIARIES

VOLUME ONE

by

JAMES KESSLER QC

SIXTH EDITION

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To my Jane

Das Ewig-Weibliche

Zieht uns hinan

(GOETHE)

INTRODUCTION

This book is concerned with the taxation of individuals who are not domiciled in the UK. Some tax rules are unique to the foreign domiciliary. I deal with these in full. Often the problems apply to both UK and foreign domiciled individuals. I address these with an emphasis on the aspects likely to concern the foreign domiciliary. The difficult topic of transfers of assets abroad is covered in full detail. I hope much of the discussion will be also helpful to those advising UK domiciled individuals and non-residents.

With care and foresight direct taxation in the UK may largely be avoided; or at least, a UK resident foreign domiciled individual need not pay much more tax than if he were not resident. The UK is tax friendly to the foreign domiciliary. It is sometimes called a tax haven (particularly in advertising material) but that is an exaggeration. A foreign domiciliary does not enjoy blanket tax exemption: there are convoluted paths to tax exemptions through the tangled jungle of UK tax legislation. Tax avoidance in the strict sense is not covered, a foreign domiciliary should rarely need it.

It is only a year since the last edition, but at present we have a frenetic pace of tax reform. Two years ago I suggested its slogan could be: "legislate first and think later".[1] Last year the slogan should be: "we will not listen".[2] This year the striking feature is wide and vague anti-avoidance provisions accompanied by guidance notes giving many examples quite inconsistent with the legislation.[3] The most important

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1 SDLT is a textbook example. The problem of "act in haste, repent at leisure" Bills is not limited to tax: see "Parliament and the Legislative Process" (HL Select Committee on the Constitution) 2004 accessible *www.publications.parliament.uk/pa/ld200304/ldselect/ldconst/173/17302.htm*.

2 Again, the problem is not restricted to tax; see Greenpeace's stunning victory following (non)consultation on nuclear power: *R (on the application of Greenpeace) v Secretary of State for Trade and Industry* [2007] EWHC 311 (Admin).

3 e.g., provisions relating to CGT losses and SDLT anti-avoidance.

developments are the following:

Parliament has passed the FA 2007.

The Tax Law Rewrite has given us the ITA 2007.

The Courts have decided *Jasmine v Wells & Hind* (tax status of invalidly appointed trustees) and *Phizackerley v IRC* (maintenance of spouse).

HMRC have published Tax Bulletin 84 (rates of tax on remitted foreign dividends) which contained a pleasant surprise for many taxpayers.

The topic of residence has seen important developments. *Gaines-Cooper v HMRC* is the next stage of an apparent HMRC campaign to bring more individuals into UK tax as residents. The partisan HMRC Brief 1/2007 was no doubt drafted with one eye on the litigation which is to follow.

The Inspectors Manual has been withdrawn with a jest.[4] We are told that updated guidance will eventually be published. Readers may not appreciate the joke. In accordance with the principles of open Government, it would have been appropriate first to publish the new guidance and only then to withdraw the old Manual! The withdrawal of the CTO Manual (eventually republished as the IHT Manual) allowed a few important statements to be quietly dropped. I rather expect that will happen again; time will tell. During the interregnum the taxpayer is entitled to assume that the old Manual still represents HMRC's view, and its statements are therefore recorded here.

The Savings and Investment Manual (which covers some of the areas of the old IM) appeared too late for this edition.

In tax matters the advisor's duty is not merely (merely?) to understand the law. He/she must explain it, clearly, record it in writing,[5] and identify the risk factors. Bizarre decisions such as *Rysaffe* and *Grimm* (happily corrected on appeal) and *Phizackerley* (not appealed) illustrate the uncertainties – or (which comes to the same thing) the lottery element in litigation. Of course, that is true of life generally:

> dass eine preiswürdigere Wahrhaftigkeit in jedem kleinen Fragezeichen

4 "After long and invaluable service to the Inland Revenue, followed by a debilitating illness lasting some five years, the Inspectors Manual has been peacefully laid to rest. It was ultimately a victim of the new business streamed HMRC but generations of Inspectors of Taxes will mourn its passing." [2007] STI 20.

5 Is this so obvious that it is unnecessary to say? It is not: *Chandrasekaran v Deloitte & Touche Wealth Management* [2004] EWHC 1378 para 72.

> liegen dürfte, welches ihr hinter eure Leibworte und Lieblingslehren (und gelegentlich hinter euch selbst) setzt, als in allen feierlichen Gebärden und Trümpfen vor Anklägern und Gerichtshöfen![6]

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.

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

This book has put on weight in the last 12 months, but that should not cause surprise. Tax legislation is so voluminous that no-one can now read it. I cannot even *lift* it.

This book seeks to state the law as at 1 August 2007.

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6 "that a more praiseworthy veracity may lie in every little question-mark placed after your favourite words and favourite theories (and occasionally after yourselves) than in all your solemn gesticulations and smart answers before courts and accusers!"
Nietzsche, *Beyond Good and Evil*, chapter 25.

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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Statutes and Statutory Instruments

CA	:	Companies Act
FA	:	Finance Act
FB	:	Finance Bill
FISMA	:	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

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

CG Manual	:	Capital Gains Manual
EI Manual	:	Employment Income Manual
IR20	:	Residence and Domicile
INTM	:	International Manual
ITH	:	International Tax Handbook
NI Manual	:	National Insurance Manual
SII Manual	:	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
EN	:	Explanatory Notes
ESC	:	Extra-statutory concession
GB	:	Great Britain
GWR	:	Gift with reservation of benefit
HMRC	:	Her Majesty's Revenue and Customs
IHT	:	Inheritance tax
IOV	:	Instrument of variation
IP	:	Interest in possession
IPDI	:	Immediate post-death interest
IT	:	Income tax
NICs:	:	National insurance contributions
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
TSI	:	Transitional Serial Interest

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CHAPTER ONE

TERMINOLOGY

1.1 "United Kingdom" and related expressions

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.

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 …

1.1.3 *"England"*

The definition of "England" is not usually an issue for tax. However, for completeness, para 5(a) Schedule 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.

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).

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.

1 See CG Manual 22070:

> 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.

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 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

Attempts to argue that discrimination between married and unmarried couples is in breach of article 14 ECHR (Prohibition of discrimination) have failed, though only narrowly.[3]

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:

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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.

> A civil partnership is a relationship between two people of the same sex ("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.

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.

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.

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
Recognised IP[4]	:	An interest in possession to which s.49 IHTA applies (interest arising before 22 March 2006, TSIs, IPDIs, disabled persons interests)
Unrecognised IP	:	Any other interest in possession

4 The terminology was suggested by Robert Venables QC.

CHAPTER TWO

FOREIGN DOMICILE TAX REFORM

2.1 Policy issues in foreign domiciliary taxation[1]

There are some strong policy arguments in favour of a lighter fiscal regime for foreign domiciliaries. One is the effect of tax competition:

(1) Foreign domiciled individuals may have a choice where to set up their home. If their tax burden was as great as that of a UK domiciliary fewer would live in the UK, and the UK economy might be the loser. Wealthy entrepreneurs, wherever domiciled, find there is no shortage of low-tax jurisdictions or preferential tax regimes to which they can move. Switzerland, for instance, has a lump sum taxation regime for non-Swiss citizens specifically targeted for this purpose.

(2) UK firms competing for expertise in the international labour market will find recruitment easier if the tax regime for foreign domiciled employees is lighter. Some potential employees could not afford to come at all if the UK tried to tax them as it does its own domiciliaries.

In other areas where the UK faces international tax competition, those making the law 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

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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); both accessible on *www.kessler.co.uk*.

> charge tax in parallel circumstances. 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. Removing the potential inheritance tax charge will help UK managers compete on an equal footing with overseas fund providers.[2]

Another consideration is fairness. It seems fair that those whose links with the UK are less should be taxed less heavily on foreign source income. This is especially so bearing in mind that "residence" does not involve a very close connection to the UK – merely passing the 183 or 91 day tests. 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 completely 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.

There are counter-arguments:

(1) Loss of tax to HMRC.

(2) Unfairness as compared with UK domiciled taxpayers.

(3) Unfair tax competition as against other countries.

Argument 1 is crucial but what will be the overall effect of any reform is very hard to tell. Argument 2 is ultimately a political issue on which views may differ. Argument 3 assumes a level of international fiscal co-operation that does not yet exist, though it may come about in the future. Effective low tax is often achieved in other countries by formal or informal concession rather than by law, but the reality is that an individual domiciled in the UK who is prepared to move to find a favourable tax

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2 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.)

regime can find one. In short he is no worse off than the foreign domiciliary who moves from his original home country to the UK. The UK system is largely[3] based on the rule of law rather than informal practice and discretion.

It is certainly a fair criticism of the current system that 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.

The IHT code has always recognised this with its deemed domicile rule, but to a large extent neutralises its effect by a generous treatment of trusts.

2.2 History of reforms of foreign domiciliary taxation

For those who think the present system is too generous, there are two ways to proceed:

(1) alter the definition of domicile for general purposes and so restrict the class who qualify for foreign domicile tax treatment;

(2) (a) alter the definition of foreign domicile for tax purposes, or
(b) alter tax laws applying to a foreign domiciliary.
(One can of course achieve the same result by either technique.)

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 IHT and CGT purposes. This was withdrawn from the Bill.[4]

In 1987 the Law Commission published recommendations for mild 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.[5]

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3 But see 9.53 (Forward tax agreements).

4 For an insider's description of the lobbying behind this, see "Inside The Treasury", Joel Barnett, Andrew Deutsch, 1982, p.28–9.

5 Law Com. No. 168: The Law of Domicile. According to Hansard HC, 16 Jan 1996 Col 487:
"The Government have decided not to take forward these reforms on the basis that,

The 1988 Consultative Document (Residence in the UK) made radical proposals. The remittance basis would be abolished. Those not resident here for seven out of 14 years (and, perhaps, who are also not UK domiciled) would qualify for a new "intermediate basis" of taxation. This would require disclosure of worldwide income (applying our extraordinarily complex rules) in order to tax it at an effective rate of 2% or less. A proposal which seemed sensible on the drawing board, but scarcely workable in practice, it was not surprisingly abandoned.

In the first edition of this book (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".[6] There is also the possibility of EU pressure for reform.[7] 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.

2.3 The background paper on residence and domicile

In 2002 a newspaper campaign emerged[8] which pressed the Government into action, or at least into the appearance of action.

The Budgets of March and November 2002 promised, and the Budget of April 2003 delivered, a "background paper" called "Reviewing the Residence and Domicile Rules as they affect Taxation". Its omissions are more interesting than its content:[9]

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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 appears to 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*.

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

7 See for instance the EU Code of Conduct for Business Taxation 98/C2/01.

8 *The Sunday Times*, 1 March 2002; *The Guardian*, 11 and 12 April 2002.

9 An outline of the present law (a rehash of IR20 but why reinvent the wheel?); one paragraph summaries of the law of 29 other countries (of insufficient detail to be of any use and generally said to be misleading).

(1) The paper recited the principles that taxation of foreign domiciliaries:

- should be fair;
- should support the competitiveness of the UK economy; and
- should be clear and easy to operate.

The paper might have cited (though it did not) Adam Smith's *The Wealth of Nations* (1776); these observations are over two centuries old. The paper did not point out (though Adam Smith did) that these objectives are to a substantial extent irreconcilable.

(2) The paper did not consider any proposals and their possible impact. In particular, it (consciously?) ignored every earlier reform proposal: the 1974 Finance Bill, the 1987 Law Commission Report, the 1988 Consultation Paper, the 1936 Codification Committee, the Royal Commissions of 1920 and 1955, and the rest of them, might never have been.

It may be unfair to criticise the (unnamed) authors of this facile document. Their instructions may have been to be totally uncontroversial; by saying nothing, there is nothing in the document to which anyone of any political view could possibly object. Whatever future developments occur, they will not occur as the result of this background paper.

In the depths of the Budget Report 2007 is this paragraph:

> The review of the residence and domicile rules as they affect the taxation of individuals is ongoing.

This statement has now been made in slightly varying forms[10] eight times

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

10 In order to avoid patent absurdity the March 2005 version deleted the claim that the Government "is considering various aspects of this issue in the light of the response to the paper published at Budget 2003". The December 2005 version (significantly?) deleted the claim that the Government "would welcome further contributions to the debate, which will then be taken forward by the publication of a consultation paper setting out possible approaches to reform".

over the last five years.[11] What is clear is that the review of foreign domicile tax has not followed the normal course of consultation, decision and implementation. In the absence of a frank explanation of what is going on, it is tempting to speculate. The most likely explanation is that the Government is inclined to do nothing, but is prevaricating to avoid announcing that decision, and/or to keep the freedom to make any reforms it chooses in the future.[12] If so, how many more times can this increasingly implausible statement be repeated before even the Government is embarrassed to do so again? The answer probably depends on media action or inaction. Another possibility is that the matter is passing from desk to desk in the civil service as the various interested parties battle it out in a debate hidden from the public. If so, changes could be announced at any time. Another possibility is that the issues are regarded as so difficult that no-one wants to make a decision at all.

2.4 Protective steps in anticipation of law reform

It is impossible to predict what (if anything) will come out of the *soi disant* review of foreign domicile taxation. It is also impossible to know what transitional rules there might be or when the new rules (whatever they are) will take effect.

The worst case scenario is no transitional relief and:

(1) abolition[13] of the remittance basis for foreign income and capital gains

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11 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:

> **Jim Cousins**: To ask the Chancellor of the Exchequer what changes have been made to residence and domicile rules relating to taxation as a consequence of the review of such rules in April 2003.
>
> **Dawn Primarolo**: The review is ongoing.

Note how Primarolo evaded the question: the correct answer is "none".

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

13 Alternatives are severe restriction; or abolition for those who have been UK resident for a substantial period of time (perhaps 17 years, in line with the IHT deemed domicile rule).

accruing to UK resident foreign domiciled individuals, so these would be taxed on an arising basis;

(2) abolition of the s.624 ITTOIA foreign domicile defence, so that a settlor would be taxed on income accruing to the trustees if he had an interest in the settlement;

(3) abolition of the foreign domicile defence to s.86 TCGA, so that a settlor would be taxed on gains accruing to the trustees (or underlying companies) if he had an interest in a non-resident settlement;

(4) abolition of the foreign domicile defence to s.87 TCGA, so that capital payments from a trust to UK resident beneficiaries would give rise to CGT to the extent that the trust has realised "trust gains";

(5) abolition of the foreign domicile defence to ss.720 and 731 ITA. This would probably not affect trusts to which the tax motive defence in ss.736-742 ITA applies;

(6) abolition of the foreign domicile defence to s.13 TCGA, so a UK resident foreign domiciled individual would be subject to tax on gains of non-resident close companies in which he is a participator.

The best case scenario is tightening the RFI remittance basis by:

(1) abolition of the source ceasing rule;

(2) abolition of the rule that a remittance *in specie* (as opposed to a remittance of money) is not taxed.

It seems that the end result is likely to be closer to the best case than the worst.

2.5 Planning in anticipation of reforms

The following planning may be considered for a UK resident foreign domiciled individual ("F").

Consider disposing of foreign situate assets on which a substantial chargeable gain would accrue. A disposal to a trust may be an appropriate way to trigger a disposal if a market sale is not desired. Likewise trustees of non-resident trusts of which F is a settlor and has an interest should consider disposals of assets in order to crystallise unrealised gains. Likewise if F or his trusts hold underlying companies, it may be desirable for these companies to dispose of assets giving rise to a chargeable gain.

Trustees of non-resident trusts should consider making capital payments to foreign domiciled UK resident beneficiaries equal to the outstanding trust gains of the trust.[14]

Consider arranging for foreign income to accrue to F, by:

(1) procuring dividends from companies owned by F or his trust;

(2) making income payments to F from trusts of which he is a settlor;

(3) paying F chargeable overseas earnings before the year end.

Terminate sources of RFI income in order to be able to remit in the following year. Remit RFI income where the source has ceased in an earlier year. Remit assets *in specie* purchased out of RFI income.

F may if he desires settle or re-settle assets transferred to him. He should take independent legal advice on this. Watch *Furniss v Dawson*.

All these steps would ideally take place before the next Budget. If there is insufficient time, it would be possible to arrange that a disposal takes place before the Budget by entering into an unconditional contract. The date of disposal is of course the date of the contract: section 28 TCGA. The contract would need to be drafted so that it was unconditional and did not fall within the scope of *Marren v Ingles* 54 TC 76.

14 On balance it seems better not to make capital payments in excess of the trust gains.

CHAPTER THREE

DOMICILE

3.1 Why does domicile matter?

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

(1) Income tax on foreign source income; see 8.1 (RFI) and 10.1 (Employment income).

(2) CGT on foreign situate assets; see 29.1 (CGT).

(3) IHT on foreign situate assets; see 33.1 (IHT: excluded property).

Domicile is also important for many non-tax purposes.

3.2 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.

The discussion of domicile in IR20 is sketchy. IHT Manual 13000 sets out a brief and uncontentious summary. 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.

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

(1) "*Domicile*" in civil law jurisdictions.[1]

(2) "Domicile" in ordinary English usage.[2]

Everyone has one and only one domicile.

3.3 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; ...
> (2) A domicile of origin may be changed as a result of adoption, but not otherwise.[3]

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

3.4 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.[4]

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1 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.)

2 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"(!)

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

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

I shall consider ‘residence’ and ‘intention’ separately.

3.4.1 *“Residence”*

“Residence” here means “residence as an inhabitant” which is something more than “presence as a traveller”.[5] 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.[6]

3.4.2 *“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. To put it another way, he need not have the positive intention to reside there permanently, it is sufficient if he has no positive intention of leaving. “Unlimited” would be a better word but even this needs clarification. *IRC v Bullock* 51 TC 522 commented on the classic dictum 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.

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

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5 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.

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

> 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.[7]

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 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.

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.

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

3.4.3 *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).[8]

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 only to be found on clear and compelling evidence. 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."[9] If that is right, then the reform often proposed of amending the burden of proof in domicile cases will have little practical effect.

3.5 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 his foreign domicile. His concern is not to acquire a UK domicile of choice.

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8 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.)

9 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 primary advice to be given to him is clear: he may live in the UK as long as he wishes from year to year but he should not form the intention to settle here permanently. Unless he 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 his stay here is short or fixed term. He should also take such practical steps as are appropriate to broadcast the absence of any intention of residing here permanently and to manifest his 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 her affairs while in the UK.

The individual should if possible retain ties with her country of origin. There are many ways by which she 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.[10] 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 declaration should be drafted carefully, in accordance with the individual's circumstances; a simple declaration of domicile is inadequate.[11]

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

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10 An additional UK Will may also be appropriate to deal with UK property.

11 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, 17.24 (Best form of will for foreign domiciled testator).

residence it might indicate an intention to remain in that country for the rest of his 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, whilst 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.

3.6 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. 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.

3.7 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 3.4 (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.[12]

3.8 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.

3.9 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.

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

3.9.1 *Acquisition of domicile of choice by dual resident*

In *Udny v Udny*,[13] 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:

> 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.[14]

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13 (1869) LR 1 Sc & Div App 441 at p.458. (Emphasis added.)

14 "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

3.9.2 *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)

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 3.9.1 (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.

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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.

The judge here is considering acquisition of a new domicile of choice.[15] 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 3.9.1 (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 3.9.1 (Acquisition of domicile of choice by dual resident).

3.9.3 *Which is the "chief" residence?*

The next question is exactly how one ascertains which of two competing residences is the chief one. This has not been seriously addressed, because in the reported cases the identity of the chief residence has been fairly clear.[16] There is helpful guidance in *Plummer v IRC* 60 TC 452. Here Miss Plummer had a domicile of origin in England. 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:

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

16 *Gaines-Cooper v HMRC* may shed further light on the question when the decision is final.

[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.

3.10 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.[17]

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 treatment or palliative care.[18] 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,[19] the individual may acquire an English domicile; it depends of course on intention in each case.

3.11 Domicile and citizenship

3.11.1 *Retention of foreign citizenship*

In *IRC v Bullock*, the Court said:

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17 (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 ..."

18 Citation of 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.

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

> 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.[20]

3.11.2 *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.[21] 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.

3.12 Married women

3.12.1 *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.

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20 51 TC 522 at 540.

21 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.

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 of course that depends on all the facts.[22]

3.12.2 *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[23] 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.

3.12.3 *Marriage ended before 1 January 1974*

In *Re Wallach* [1950] All ER 199, a widow died five days after the death

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22 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.

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

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).

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.[24] 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.

3.13 Refugees and illegal immigrants

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, that would not, by itself, show that he had acquired an intention to reside in the UK permanently.

A person in the UK illegally may become domiciled here, though the illegality is a factor in deciding whether he has a genuine intention of remaining in the UK: *Mark v Mark* [2006] AC 98.

3.14 HMRC rulings on domicile and ordinary residence

3.14.1 *Statutory rulings and appeals procedures*

Sections 42 and 43 ITEPA provide a ruling procedure for employment income:

> **42 Commissioners to determine dispute as to domicile or ordinary residence**
> (1) This section applies if, in connection with any of the provisions listed in subsection (3), there is a dispute as to whether a person is or has been ordinarily resident or domiciled in the UK.
> (2) The question whether the person is or has been so resident or

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

domiciled is to be referred to and decided by the Commissioners for HMRC.

(3) The provisions referred to in subsection (1) are —

[*List not printed here; it appears to include every relevant provision in ITEPA: ss.15, 21, 22, 23, 25, 26, 341, 342, 355, 376, 390*]

43 Appeal against Commissioners' decision on domicile or ordinary residence

(1) A person who has been given notice of the decision of the Commissioners for HMRC on a question under section 42 may, if aggrieved by that decision, appeal to the Special Commissioners.

(2) The notice of appeal must be given to the Commissioners within 3 months after the date on which the person is given notice of the Commissioners' decision.

Section 9(2) TCGA applies the same procedure for CGT. A formal ruling for IHT will be made by a notice of determination, see s.221 IHTA; or for other IT purposes by means of an assessment.

It is difficult to see the point of this special procedure. The sections could be repealed so that ordinary assessment and appeals principles would apply; but they do no particular harm.

3.14.2 *HMRC practice*

EIM 42806 provides:

Claims to be not domiciled in the UK: Action on receipt of claim

If an employee claims to be not domiciled in the UK you can only consider the claim if domicile is immediately relevant to the computation of the tax liability.

In some circumstances you can admit the claim without submission to Centre for Non-Residents.

If you receive a non-domicile claim you should refer to the flowchart at paragraph 3.4 of the Residence Guide (RG3.4) to decide if domicile is relevant.[25] If it is relevant, you should then refer to the flowchart at RG3.5.

[The flowchart at RG3.5 is as follows:]

25 [Author's Note] Para 3.4 does not contain a flowchart, though it does note that Irish source income is always taxed on an arising basis.

Do all the following conditions apply?

- The claimant was born outside the UK
- The claimant's father was domiciled outside the UK at the time the claimant was born
- The claimant came to the UK for the purposes only of employment (including self-employment) and intends to resume residence abroad when that employment ceases

YES

- Accept that the individual is not domiciled in the UK
- Note to issue the Non residence, etc pages with the Tax Return

NO

- Issue form DOM1
- Refer the completed form and the file to CNR (Residence Advice and Liabilities) Bootle

If domicile is not relevant, you should not admit the claim and explain to the claimant that domicile is not material.

IM1635 provides:

Claim of non-domicile in UK [January 2006]
An individual's domicile is of concern to the Revenue only where it is relevant to the computation of liability. The instruction at EIM42804 should be followed for cases wholly within Schedule E. In other cases, domicile will only be relevant where the taxpayer has income arising abroad, or gains arising on assets situated outside the UK, which will not be wholly remitted to the UK.
If an individual claims to be not domiciled within the UK, and the case is not wholly within Schedule E (see EIM42804), issue form DOM1. If the completed form DOM1 shows that domicile is immediately relevant, submit it together with the file to The Centre for Non-Residents Bootle for a ruling. If form DOM1 shows that domicile is not relevant, decline to examine the claim to be not domiciled.

Tax Bulletin 29 (June 1997) provides:

> Domicile
> Initial non-domicile claims may be made on form DOM1, form P86[26] or in the SA [Self Assessment] tax return. We will continue to deal with initial non-domicile claims which are made before we have received the return for the year in which the claim is made. And we will let claimants know how their claim to be non-domiciled in the UK has been treated. But we may ask questions to check the validity of the claim as part of a formal TMA 1970, s9A enquiry into the SA tax return.
> ...
> With domicile it is likely that ticks in boxes 9.5 and 9.28 on the "NON-RESIDENCE ETC" pages of a return will prompt a review of an individual's domicile which may lead to the issue of a TMA 1970, s9A enquiry. And we may issue a form DOM1 as part of a TMA 1970, s9A enquiry into the return. But where, for example, an individual:
> – has a domicile of origin outside the UK; and
> – has come to the UK only for the purpose of employment; and
> – intends to resume residence abroad when the employment ceases; and
> – has given such information on a form P86
>
> we are unlikely to issue an enquiry into the domicile position.
> A tick in box 9.29 of the "NON-RESIDENCE ETC" pages is also likely to prompt a review of an individual's domicile and the issue of a TMA 1970, s9A enquiry. At that stage we will review the individual's domicile from the date of any change in circumstances. ...[27]

3.14.3 *Obtaining a HMRC ruling on domicile*

HMRC practice is not to comment on an individual's domicile unless it is immediately relevant to the determination of a current tax liability. To meet this requirement, some positive steps may be needed, for example:

(1) A UK resident individual might arrange to receive foreign source income and retain the income outside the UK.

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26 Entitled "Arrival in the UK".
27 Text omitted here is discussed at 6.21 (Year of acquisition of UK domicile).

(2) A UK resident individual might realise a chargeable gain on a foreign asset and retain the gain outside the UK. The gain must exceed the available annual exemption.

(3) A resident or non-resident individual might transfer foreign property to a settlement. The value transferred must exceed the nil rate band (and available exemptions).[28]

In cases (1) and (2) the individual will tick the relevant box on his Self Assessment tax return claiming to be domiciled outside the UK and that his foreign domicile is relevant to his tax position. Unremitted foreign income or gains would be taxable on the arising basis if he were to be UK domiciled but not if he were domiciled abroad. A formal consideration of the domicile of the individual will then be necessary by HMRC.

In case (3) the individual strictly has no tax return to submit but the transfer to the trust would be a chargeable transfer on which IHT would arise if he were domiciled in the UK. If he were domiciled outside the UK the transfer would be of excluded property and no tax would arise. HMRC would therefore need to consider the individual's domicile to determine whether any tax arises on this transfer. This route is not open to an individual who is deemed UK domiciled for IHT, but wishes to obtain a ruling on his actual domicile for IT or CGT.

If the amount involved only gives rise to a nominal tax liability, HMRC may concede domicile in that year without raising an enquiry, and so without prejudice to subsequent years. I suggest the amounts involved should be sufficient to give rise to (say) £20,000 tax liability.

3.14.4 *Are HMRC bound by their ruling?*

It is an interesting question how far HMRC are bound by any ruling they may give on domicile. In principle they would not be precluded from

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28 Other possibilities which form DOM1 contemplates for a UK resident are:

(1) A claim for UK tax relief in respect of contributions to a non-UK pension scheme or retirement benefit plan which are incurred out of remuneration received from an employer who is not resident in the UK.

(2) A claim in respect of costs in travelling between the country in which the individual normally lives and the UK which have been borne or reimbursed by the employer.

(3) Unremitted overseas chargeable earnings.

taking a different view at a later date even if the individual's circumstances remained entirely unchanged. However, it would be most unusual (and possibly the subject of a successful application for judicial review) if they were to resile from their earlier ruling, unless it could be suggested that the individual had not disclosed all relevant information or there had been some change in circumstances.

3.15 Inheritance tax deemed domicile

For the IHT deemed domicile rules, see 31.1 (Three classes of domicile for IHT).

3.16 Domicile of company

The domicile of a company is its place of incorporation.[29] Domicile of a company is only rarely significant for tax or any other purposes.

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

CHAPTER FOUR

RESIDENCE OF INDIVIDUALS

4.1 Why does residence matter?

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

(1) The charge to income tax on foreign income which applies to residents.[1]

(2) The exemption for certain UK source income of non-residents.[2]

(3) Capital gains tax.[3]

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. Much more important in practice is HMRC booklet IR20, supplemented by other HMRC statements.

4.2 Why does ordinary residence matter?

Ordinary residence does not matter as much as residence. It is possible to be UK resident but not ordinarily resident and this is the only situation where the concept of ordinary residence matters in practice. It is not possible to give a full list. The main differences (all advantages) for an

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1 See 8.1 (Investment income) and 10.1 (Employment income).
2 s.811 ITA.
3 See 29.1 (CGT).

individual who is resident but not ordinarily resident in the UK (compared to one who is resident *and* ordinarily resident) are as follows:

(1) Certain anti-avoidance rules do not apply:

   (a) Deemed remittances.[4]

   (b) Transfer of assets abroad.[5]

(2) Exempt gilts owned by a non-ordinarily resident person are excluded property for IHT.[6] Interest on exempt gilts is not subject to income tax if the owner is resident but not ordinarily resident (contrast other types of interest, taxable on an arising or remittance basis).

(3) Different employment income rules apply.[7]

(4) The RFI remittance basis applies even if UK domiciled.[8]

(5) Different NIC rules apply.[9]

There is no statutory guidance on the meaning of ordinary residence. Like simple residence, the meaning has been discussed in the case law but IR20 is much more important in practice.

4.3 Temporary UK purpose and 183 day rules

4.3.1 *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

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4 See 9.39 (Deemed remittances).
5 See 15.1 (Transfer of assets).
6 See 33.3 (Exempt gilts).
7 See 10.1 (Employment income).
8 See 9.5 (Who qualifies for the RFI remittance basis?).
9 See 20.5 (Employed in GB); 20.6 (Residence requirements).

[i] for some temporary purpose only and
[ii] with no view[10] to establishing the individual's residence in the UK, and

(b) in the tax year in question the individual has not actually resided in the UK at one or several times for a total period equal to 183 days (or more).

In determining whether an individual is within paragraph (a) ignore any living accommodation available in the UK for the individual's use.[11]

I call this "the temporary UK purpose rule". Although that label does not quite correctly summarise the conditions of s.831(1), no label could do so. 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 inordinate detail.[12]

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10 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 all mean the same thing.

11 I deal with this paragraph at 4.5 (Accommodation in the UK).

12 "(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 paragraph 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

> *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).[13]

Thus the consequences of the temporary UK purpose rule is to treat the individual as non-resident for certain purposes.

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 think, 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 cannot be helpful if it uses the word "residence" without explanation, as happens here. IR20 provides a (relatively) clear and workable set of rules for those coming to the UK, but this should not be said to be based on the temporary UK purpose rule.

4.3.2 *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

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income' and 'social security income'."

For completeness, s.831(3) ITA provides:

"Paragraph (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.

13 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.

rewritten in plain English than it was before. 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 *has* actually resided[14] in the UK at one or several times for a total period equal to 183 days (or more).

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). 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.
> 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 <u>UK resident</u> 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 <u>UK resident</u> for the purposes of any charge under a provision mentioned in section 830(2) of ITTOIA 2005.

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14 ITA EN para 2479 provides:
> "Subsection (1)(b) retains the expression "actually resided" rather than adopting the expression "spent", as "actually resided" may not in every circumstance be synonymous with"spent"."

But I think the expressions mean the same thing.

Thus the consequences of the 183 day rule is to treat the individual as UK resident for certain purposes. The rule is relatively precise, since it is easy to count the 183 days.

4.3.3 *Temporary purpose and 183 day rules: comments*

Section 831 raises puzzling questions, if one takes it seriously. First, it only applies for certain income tax purposes, and the question of residence may arise for other income tax purposes.[15] No-one wants *two* income tax definitions of residence! There are two solutions to this problem. One would be to say that the section only states what would in any event be the normal meaning of residence. Then the section is otiose and pointless. The alternative is that the section should be regarded as laying down rules which apply for income tax generally. Then the enormously detailed lists in section 831(2) specifying types of income which are affected are unnecessary and inappropriate. This is the lesser of the two evils, and HMRC agree. Inspectors Manual para. 43 provides:

> 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 the principles of IR20 (supposedly based on these rules) are applied for NIC purposes even though NIC has no equivalent statutory provisions.

Secondly, the section is not expressed as a definition of residence. The section provides that one class of person is treated[16] as resident; and another is treated as non-resident. But this is (almost) universally ignored so the provisions are regarded as part of a definition of residence (if they are regarded at all).

Thirdly, the two rules only cover some of the possible permutations of fact:

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15 In particular it may arise for UK source income: s.811 ITA.

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

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 is

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

4.4 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. But the main problem remains that "occasional residence abroad" is hopelessly vague in the modern world.

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.

IR20 provides a (relatively) precise and workable set of rules for those who leave the UK, but this should not be said to be based on the occasional residence abroad rule.

4.5 Accommodation in the UK

It is best to approach the statutory provisions historically. 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.[17]

This is called "the available accommodation rule". John Avery Jones states tactfully that "it is difficult to see how the available accommodation rule ever arose"; more bluntly, the rule did not exist.[18] The rule was abolished by statute, in two stages.

From 1956, the 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.

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17 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...

18 [1993] BTR 286. The rule was inconsistent with the case law: see 4.8 (Case law). 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 ... (although that is now subject to s.336(3) ICTA) [now s.831(1)[B] ITA]".

(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):

(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.[19]

In 1993 this was extended. The drafting is opaque. Section 831(1)[A] ITA provides 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 has not actually resided in the UK at one or several times for a total period equal to 183 days (or more).

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

[B] In determining whether an individual is within paragraph (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.[20] One purpose

19 This uses terminology discussed elsewhere: If s.830 mattered, see 10.5 (incidental duties); and 4.12.1 ("Work full time abroad").
20 Except for full-time workers abroad.

where one has regard to it is the occasional residence abroad rule.[21] Perhaps there are others.

In practice the significance of available accommodation can be found in IR20.

For those who leave the UK under the three years abroad practice,[22] IR20 para. 2.8 provides:

> If you claim that you are no longer resident and ordinarily resident, we may ask you to give some evidence that you have left the UK permanently, or to live outside the UK for three years or more. This evidence might be, for example, that you have taken steps to acquire accommodation abroad to live in as a permanent home, *and if you continue to have property in the UK for your use, the reason is consistent with your stated aim of living abroad permanently or for three years or more.*
> (Emphasis added)

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.

For those who come to the UK, IR20 para. 3.7 provides that a longer term visitor who comes to and "remains" in the UK is treated as resident in the year of arrival if:

> you own or lease accommodation in the UK.[23]

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21 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.

22 See 4.16 (The three-years-abroad practice).

23 See 4.25 (Longer term visitors). This was HMRC's intention when enacting the original 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.

This can be reconciled with s.831(1)[B] ITA because the disregard applies for the temporary UK purpose rule, and someone who "remains" in the UK is not here for a temporary purpose.[24]

4.6 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.

The drafter was understandably unsure whether this would incorporate the 183 day and temporary UK purpose rules which (supposedly) only apply 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 to capital gains tax on chargeable gains accruing in any year of assessment if and only if the period (or the sum of the periods) for which he is resident in the UK in that year of assessment exceeds 6 months.
> (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.

The reference here is six months, rather than 183 days, but it comes to the same thing.[25]

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24 Or perhaps because the statutory disregard applies to accommodation *available* for use whereas IR20 is concerned with *ownership*.

25 *Wilkie v IRC* 32 TC 495. This is so even if the tax year includes 29 February (a leap year) for then the tax year is 366 days so 183 days comprises half the year. Inspectors Manual para.50 shows that HMRC apply the 183 day rule whether or not the year is a leap year:

> "**Residence or non-residence: six months test**
> When calculating whether an individual has spent 183 days in the United Kingdom in the tax year (whether or not the year is a leap year), both the day of arrival in and the day of departure from the United Kingdom should be

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

4.7 Dual residence/dual ordinary residence

Inspectors Manual paragraph 36 correctly states:

> An individual may be resident and ordinarily resident in more than one country at the same time. An individual cannot therefore substantiate a claim to be not resident and not ordinarily resident in the UK merely by proving residence and ordinary residence abroad.

4.8 Case law

A person who does not meet the 183 day rule may still be resident here, but in what circumstances? 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 pleasure. ...
>
> 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,

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excluded from the count."

But the number of days in consecutive months may vary between 181 and 184, so for a person who is resident in consecutive months it may (arguably) make a difference.

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).

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.

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 Special Commissioners (*Zorab*).

[3] no duration is prescribed by statute 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; also, birth, family and business ties, the nature of visits and the connections with this country, may all be relevant (*Zorab*; *Brown*).[26]

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26 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."

[4] 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 section 336(3) ICTA).
[5] 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*).
[6] 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*).[27]

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.[28]

The case law on ordinary residence is just as 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.[29]

"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 would be valuable. Unfortunately this line of enquiry leads nowhere. There is no clear definition of "habitual residence".[30] Although the House of Lords recently stated that habitual residence and ordinary residence are interchangeable

27 *Gaines-Cooper v HMRC* [2007] STC (SCD) 23 at [165] referring 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.

28 *Taxation*, 3 December 1992, Vol 130, p.234.

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

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

concepts,[31] the point was not fully argued. Some cases suggest that habitual residence is "something more than" ordinary residence,[32] though that "something more" is elusive. It has also been said that the concepts merely share a "common core of meaning".[33]

In this hopeless uncertainty, HMRC practice set out in IR20 rides (more or less) to the rescue.

4.9 IR20 categorisation in outline

IR20 divides residence into various categories. Leaving aside the 183 day rule, the primary distinction is between:

(1) those leaving the UK; and

(2) those coming to the UK.

These are subdivided as follows:

(1) *Leaving the UK* is divided into three understandable categories:

  (a) the full-time work abroad practice;

  (b) the three years abroad practice;

  (c) The "year out" category (not mentioned in IR20).

(2) *Coming to the UK* is divided in a more confusing way:

  (a) the three years in the UK practice;

  (b) visitors to the UK, not within (a), a category divided into:
    (i) short-term visitors:

      [A] indecisive visitors;
      [B] intentional visitors;

31 *Mark v Mark* [2006] 1 AC 98 at [33].
32 *Cruse v Chittum* [1974] 2 All ER 940, at 943.
33 *Nessa v Chief Adjudication Officer* [1999] 1WLR 1937 at 1941.

(ii) longer term visitors.

4.10 The 183 day rule

IR20 para 1.2 recaps the 183 day rule:

> You will always be resident if you are here for **183 days** or more in the tax year. **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.

This has a sound basis in the statutory 183 day rule.[34]

4.11 Short absences

IR20 provides:

> **Short absences**
> 2.1 You are resident and ordinarily resident in the UK if you usually live in this country and only go abroad for short periods – for example, on holiday or on business trips.

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

4.12 The full-time work abroad practice

IR20 continues:

> **Working abroad**
> 2.2 If you leave the UK to work full-time abroad under a contract of employment, you are treated as not resident and not ordinarily resident if you meet **all** the following conditions
> - your absence from the UK and your employment abroad both last for at least a whole tax year;
> - during your absence any visits you make to the UK:
>
> (i) total less than 183 days in any tax year, and

34 See 4.3 (Temporary purpose and 183 day rules).

> (ii) average less than 91 days a tax year. ...
> [See para. 4.20 (Calculating annual average visits).]
>
> 2.3 If you meet all the conditions in paragraph 2.2, you are treated as not resident and not ordinarily resident in the UK from the day after you leave the UK to the day before you return to the UK at the end of your employment abroad. You are treated as coming to the UK permanently on the day you return from your employment abroad and as resident and ordinarily resident from that date.
>
> If there is a break in full-time employment, or some other change in your circumstances during the period you are overseas, we would have to review the position to decide whether you still meet the conditions in paragraph 2.2. If at the end of one employment you returned temporarily to the UK, planning to go abroad again after a very short stay in this country, we may review your residence status in the light of all the circumstances of your employment abroad and your return to the UK.
>
> If you do not meet all the conditions in paragraph 2.2, you remain resident and ordinarily resident unless paragraphs 2.8, 2.9 apply to you. Special rules apply to employees of the European Community (see paragraph 2.14).
>
> 2.4 The treatment in paragraph 2.3 will also apply if you leave the UK to work full-time in a trade, profession or vocation and you meet conditions similar to those in paragraph 2.2.

I refer to this as "the full-time work abroad practice".

4.12.1 *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 IR20:

> **Meaning of 'full-time'**
>
> 2.5 There is no precise definition of when employment overseas is 'full-time', and a decision in a particular case will depend on all the facts. Where your employment involves a standard pattern of hours, it will be regarded as full-time if the hours you work each week clearly compare with those in a typical UK working week. If your job has no formal structure or no fixed number of working days, we will look at the nature of the job, local conditions and practices in the particular occupation to decide if the job is full-time.
>
> 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.[35]

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 10.5 (Incidental duties).

4.12.2 *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.

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

I find this bizarre, and suggest 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. IR20, para. 2.5 (set out above) waters this down to a "perhaps". But in practice the point will not often arise.

4.13 Seafarers and other wanderers

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. Captain Rogers was held to be resident here. The Court noted that he had no other residence and a man must have a residence somewhere. The UK was the only possibility. (The ship was not regarded as a residence.)

The view that one can spend a year outside the UK and still be UK resident is supported by s.829(2) ITA.[36]

However, HMRC practice is now quite different and the full-time work abroad practice is applied. 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.

36 "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)

The *Rogers* principle will apply to those who leave the UK to wander the world for a year without coming back to the UK (backpacking gap-yearers, maybe, or those on a leisurely world cruise). But in practice this is not very likely to arise.

4.14 The accompanying spouse concession

IR20 provides:

> **Accompanying spouse**
> 2.6 If you are the husband or wife of someone who leaves the UK within the terms of paragraph 2.2 or 2.4 and you accompany or later join your spouse abroad, you may also by concession (ESC A78) be treated as not resident and not ordinarily resident from the day after your departure to the day before your return, even if you are not yourself in full-time employment abroad. This applies where:
> - you are abroad for a complete tax year, and
> - during your absence any visits you make to the UK
>   (i) total less than 183 days in the tax year, or
>   (ii) average less than 91 days a tax year.
>   [see para. 4.20 (Calculating annual average visits).]

I refer to this as "the accompanying spouse concession". The concession (like all concessions) applies to civil partners,[37] though IR20 has not yet been re-written to reflect this.

4.15 "Year out" route to 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.

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37 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."

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.

HMRC relied on *Rogers v Inland Revenue*.[38] 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:

(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

38 See 4.13 (Seafarers). A court may be less sympathetic to HMRC in a similar case now that HMRC are known to ignore *Rogers* in practice.

may acquire non-residence by a "year out". I refer to this as "the year out" route to 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.[39] 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".

4.15.1 *HMRC practice*

IR20 (deliberately?) omits to mention the year out route to non-residence. HMRC leaflet NRN1 provides at question 1:

> Were you present in the UK at any time during the year ended 5 April 2004?
> If "NO", you are not resident in the UK.

But it is inevitable that a short guide such as NRN must over-simplify. The Inspectors Manual is more cautious at paragraph 36:

> An individual who is not in the UK at any time during a particular tax year is not *normally* regarded as resident for that year. If, however, his absence for the whole of the year is an exception to or a temporary break in his usual mode of life, he is regarded as remaining ordinarily resident except in certain circumstances mentioned in IM42.

This is somewhat overgenerous to HMRC (depending, however, exactly what nuance one gives to "temporary" or "exceptional").

4.15.2 *"Year out" and ordinary residence*

A question arises whether an individual can be ordinarily resident in the UK but not resident. The natural meaning of the words, and a review of the income tax cases, *Lysaght* and *Levine,* might suggest not. However,

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

the CGT legislation is clearly drafted on the basis that this is possible. This is also HMRC's view: see IR20 and Inspectors Manual para. 36:

> An individual may be ordinarily resident, though not resident in the UK for a given year, and vice versa (see, for example, IM42 and IM45). ... An individual who is not in the UK at any time during a particular tax year is not *normally* regarded as resident for that year.

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.

In *Reed v Clark*[40] the taxpayer became ordinarily resident in the USA. Although the point was not an issue in the case, and the Judge did not address it, it would seem to follow that Dave Clark ceased to be ordinarily resident in the UK in his year out. However, it is apparent from the above passages that HMRC would not accept that.

4.16 The three-years-abroad practice

IR20 provides:

> **Leaving the UK permanently or indefinitely**
> 2.7 If you go abroad permanently [*or for a period of three years or more in accordance with para. 2.8*],[41] you will be treated as remaining resident and ordinarily resident if your visits to the UK average 91 days or more a year ...[42]

IR20 then turns to those who do not average 91 UK days:

> 2.8 [a] If you claim that you are no longer resident and ordinarily resident, we may ask you to give some evidence that you have left the UK permanently, or to live outside the UK for three years or more. This

40 See 4.15 (Year out route to non-residence).

41 These words are not in IR20 but the context requires them.

42 The omitted text concerns methods of calculation discussed in para. 4.20 (Calculating annual average visits).

> evidence might be, for example, that you have taken steps to acquire accommodation abroad to live in as a permanent home, and if you continue to have property in the UK for your use, the reason is consistent with your stated aim of living abroad permanently or for three years or more.
>
> [b] If you have left the UK permanently or for at least three years, you will be treated as not resident and not ordinarily resident from the day after the date of your departure providing:
>
> - your absence from the UK has covered at least a whole tax year, and
> - your visits to the UK since leaving
>   - (i) have totalled less than 183 days in any tax year, and
>   - (ii) have averaged less than 91 days a tax year.
>
>   [See para. 4.20 (Calculating annual average visits.]

Para 2.8[b] should logically come before 2.8[a], because [b] sets out the rule and [a] sets out the evidence HMRC require to be satisfied that the conditions of the rule are met. IR20 continues:

> 2.9 [a] If you do not have this evidence, but you have gone abroad for a settled purpose (this would include a fixed object or intention in which you are going to be engaged for an extended period of time), you will be treated as not resident and not ordinarily resident from the day after the date of your departure providing:
>
> - your absence from the UK has covered at least a whole tax year, and
> - your visits to the UK since leaving
>   - (i) have totalled less than 183 days in any tax year, and
>   - (ii) have averaged less than 91 days a tax year.
>
> [b] If you have not gone abroad for a settled purpose, you will be treated as remaining resident and ordinarily resident in the UK, but your status can be reviewed if:
>
> - your absence actually covers three years from your departure, or
> - evidence becomes available to show that you have left the UK permanently
>
> providing in either case your visits to the UK since leaving have totalled less than 183 days in any tax year and have averaged less than 91 days a tax year.

The IR20 heading "leaving the UK permanently or indefinitely" is not an accurate label. I refer to the rules in IR 2.8 and 2.9 together as "the three-years-abroad practice". The practice applies to a person who leaves the

UK permanently or for (at least) a three year period.

There is not much difference between IR20 para 2.8 and 2.9[a]. Para. 2.8 is a case where the person provides "some evidence" that he has left permanently or for three years. Para. 2.9[a] is a case where the individual merely states his intention to leave permanently or for a three year period, and the same applies.[43] In either case the person is treated as non-resident by the time his next tax return is due.

Para. 2.9[b] is a case where a person leaves the UK but is not able to say that he will be away for three years, i.e. he does not know whether he will stay abroad or not. This category seems to have the extraordinary status of provisional and uncertain residence.[44] Suppose T is UK resident until year 1. In year 1 T spends 91 days here but he does not know if that will continue for three years; T may think he is UK resident in year 1 but he cannot be sure. If in years 2 and 3 T continues to average less than 91 days in the UK, he retrospectively finds that he is not resident in year 1 after all! The Consultation Document "Residence in the UK" (1988) recognises the concept of provisional residence at 4.6:

> It may be necessary, for example, to examine a person's activities for a period of years ... after the year in question. Such an enquiry means that decisions must be provisional and liabilities may remain unsettled for a number of years.

In practice problems may not arise, perhaps because taxpayers feel able to say whether or not they intend to reside outside the UK for three years. But apparently HMRC have been scrutinising claims of mobile workers and found many doubtful.[45]

4.17 Requirement to "leave" the UK

Suppose a person who is UK resident decides to average less than 91 days a years in the UK, so he meets the 91 day test over a three year period.

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43 If an individual states "I intend to remain out of the UK for three years" then, I assume, in the wordy formula of para. 2.9[a], he can say he has left for a "settled purpose" (which includes "a fixed object or intention in which he is going to be engaged for an extended period of time").

44 For another case where this arises see 4.24.2 (Intentional visitors).

45 See 4.18.2 (Mobile workers and the three years abroad practice).

The natural reading of IR20 is that he becomes non-resident under the three years abroad practice. Just recently, however, HMRC have sought to read in a further requirement. The first hint of this was in the statement on mobile workers, that the individual must not "usually live" in the UK and must "genuinely" leave the UK.[46] This requirement is not clearly expressed in IR20. It may be embryonically present in the reference to "visits" and "leaving the UK", but I would not have read the words that way. In the 5th edition of this book I expressed the view that it was a Revenue afterthought to catch mobile workers. But now it is being used to restrict the three years abroad practice much more than that.

HMRC Brief 01/07[47] provides:

> The '91-day test' is set out in Chapters 2 & 3 ('Leaving the UK' and 'Coming to the UK – Short term visitors') of the booklet IR20: Residents and non-residents. This guidance is clear [!] that the '91-day test' applies only to individuals who have either left the UK and live elsewhere or who visit the UK on a regular basis. Where an individual has lived in the UK, *the question of whether he has left the UK has to be decided first.* Individuals who have *left* the UK will continue to be regarded as UK-resident if their visits to the UK average 91 days or more a tax year, taken over a maximum of up to 4 tax years. ...
>
> (Emphasis added).

What, then, is required to "leave" the UK? The Brief can give only the vaguest of answers:

> [1] In considering the issues of residence, ordinary residence and domicile in the Gaines-Cooper case[48], the Commissioners needed to build up a full picture of Mr Gaines-Cooper's life. A very important element of the picture was the pattern of his presence in the UK compared to the pattern of his presence overseas. The Commissioners decided that, in looking at these patterns, it would be misleading to wholly disregard days of arrival and departure. They used Mr Gaines-Cooper's patterns of presence in the UK as part of the evidence of his lifestyle and habits during the years in question. Based on this,

46 See 4.18.1 (Mobile workers and the full-time work abroad practice).
47 [2007] STI 132.
48 [2007] STC (SCD) 23.

> and a wide range of other evidence, the Commissioners found that he had been continuously resident in the UK.
> [2] From HMRC's perspective, therefore, the '91-day test' was not relevant to the Gaines-Cooper case since Mr Gaines-Cooper did not *leave* the UK.

Point [1] is correct, but of course, the Special Commissioners were not trying to apply IR20. They were seeking to apply the general law of residence, whatever that is. It follows from [2] that unless and until a person *becomes non-resident as a matter of law,* he will not become entitled to use the 91 day test. Since the purpose of IR20 historically was to replace the uncertainties of the law with a workable practice, this is a major change of practice. HMRC implausibly deny this:

> HMRC can confirm that there has been no change to its practice in relation to residence and the '91-day test'. HMRC will continue to:
> - follow its published guidance on residence issues, and apply this guidance fairly and consistently;
> - treat an individual who has not left the UK as remaining resident here;
> - consider all the relevant evidence, including the pattern of presence in the UK and elsewhere, in deciding whether or not an individual has left the UK;
> - apply the '91-day test' (where HMRC is satisfied that an individual has actually left the UK) as outlined in booklet IR20, normally disregarding days of arrival and departure in calculating days under this 'test'.

Disclosure in the course of judicial review proceedings now underway by Mr Gaines-Cooper and others caught out by the HMRC change in practice will expose this statement to a scrutiny which it may not be able to withstand; it will be interesting to see the result.

Shepherd v HMRC[49] concerned an airline pilot. He arranged to average 80 days a year in the UK, so should have become non-resident under the three-years abroad practice. He was held to be resident here, because his main home was in the UK and he spent more time there than anywhere else. The fact that he apparently satisfied IR20 did not help because the

49 [2006] STC 1821.

Court had to apply the law and ignore IR20. Again, the correct remedy may have been judicial review.

In practice, one should not now rely on the three-years abroad practice unless one can identify a clear date of departure and be confident that one has "left" the UK. Unfortunately, it is impossible to say exactly what is necessary to "leave" the UK. The most one can say is that *Gaines-Cooper* and *Shepherd* offer illustrations of what is insufficient to leave.

The requirement to "leave" the UK also applies to the full-time work abroad practice but except for mobile workers (discussed in the next section) anyone who works full-time abroad is likely in practice to have to leave the UK.

4.18 Mobile workers

Tax Bulletin 52 provides:

> **Personal Residence: How The Rules Apply To 'Mobile Workers' Living In The UK**
>
> 1. This note explains how the Inland Revenue consider the rules of residence and ordinary residence apply to 'mobile workers', individuals who
>
> [a] usually live in the UK but
>
> [b] make frequent and regular trips abroad in the course of their employment or business.
>
> 2. For this purpose:-
>
> [a] the expression 'mobile workers' includes for example lorry or coach drivers who drive their vehicle to and from the Continent; those working on cross-Channel transport; and sales persons who make frequent short business trips abroad;
>
> [b] individuals usually live in the UK if their home continues to be in the UK and their settled domestic life remains here;
>
> [c] trips abroad are frequent and regular where work patterns are such that individuals make trips abroad every two or three weeks or more often. It would for example include someone travelling to France most Sundays or Mondays in connection with their employment but returning to the UK by or at the following weekend.

Definition 2[b] is tendentious because the expression "individuals usually live in the UK" does not by any means connote "their home continues to be in the UK and their settled domestic life remains here". Thus the statement actually applies to individuals who:

(1) whose home and settled domestic life is in the UK, and

(2) who make frequent and regular trips abroad in the course of their employment or business.

The Bulletin continues:

> **Residence status**
> 3. Such individuals sometimes claim to be not resident and not ordinarily resident in the UK, simply on the basis of the limited number of days they spend in the UK in a tax year. While the precise facts of a particular case are always paramount in deciding residence status, we consider that where there are no special circumstances, such individuals are likely to remain resident and ordinarily resident here for tax purposes.

4.18.1 *Mobile workers and the full-time work abroad practice*

Why are mobile workers not non-resident under the full-time work abroad practice? Tax Bulletin 52 continues:

> 4. General guidance on how the residence rules normally apply to those leaving the UK is set out in chapter 2 of booklet IR20, 'Residents and non-residents'. Paragraph 2.1 sets out the general principle that individuals who usually live in the UK and only go abroad for short periods, for example on business trips, remain resident and ordinarily resident here. Paragraph 2.2 explains a long-standing Revenue practice in the case of individuals who go abroad for full-time employment. They are treated as not resident and not ordinarily resident from the day after their departure if:-
> [1] they have left the UK to work full-time abroad under a contract of employment, and
> [2] their absence from the UK and the employment abroad both last for at least a whole tax year, and
> [3] during their absence any visits they make to the UK total less than 183 days in any tax year; and average less than 91 days a tax year over the period of absence up to a maximum of four years.

> All these conditions must be met for this practice to apply. It is not sufficient merely for the day counting tests to be met.

Having correctly restated IR20, the Bulletin explains:

> 5. The treatment under paragraph 2.2 [the full-time work abroad practice] is aimed at individuals who leave the UK for a complete tax year to live and work on assignments abroad. It might for example apply (assuming all the conditions mentioned above are met) to lorry drivers who go to live in Sweden to transport goods within Scandinavia for their firm. In the case of individuals living in the UK but making regular short trips abroad, it is questionable whether
> [1] they have genuinely left the UK in a residence sense, or
> [2] can be said to be working full-time abroad; and
> [3] they could not satisfy the condition that:
> [i] their absence and
> [ii] the employment abroad
> both last for a whole tax year.
> They have not in our view made the clear break with the UK that the practice in paragraph 2.2 requires.

Dealing with these points separately:

[1] This can now be seen as the new requirement to "leave" discussed in the last section. Note the circular reasoning. To determine whether a person is UK resident one apparently asks whether they have left the UK "in a residence sense"!

[2] Point [2] is correct for mobile workers who do some UK work: see 4.12.1 (Meaning of "full-time work abroad"). That would apply (for example) to "lorry drivers who drive their vehicles to and from the continent". They do not qualify for the full-time work abroad practice. But it would not apply to commuters whose home is in the UK and who work abroad.

[3] I do not understand [3], but in the circumstances it hardly matters.

Another way to attack mobile workers would have been to say that the "normal" rule of ignoring days of arrival/departure should be disapplied, but HMRC wisely did not pursue this line.

Having dealt with the important matter of practice and IR20, HMRC felt they should acknowledge the existence of law:

> 6. The statutory provisions concerning the residence status of individuals are Sections 334 and 336 ICTA. We have taken legal advice on how these apply to mobile workers. Our view is as follows:-
>
> - Section 334 broadly provides that Commonwealth citizens who have been ordinarily resident in the UK remain UK resident if they leave the UK "for the purpose only of occasional residence abroad". On the basis of case law, we consider that individuals who have no settled residence abroad, have no intention to stay abroad indefinitely, and return to a UK base and a UK abode at the end of each assignment, are unlikely to be able to show that they are absent for other than "occasional residence" abroad.
> - Section 336 [now s.831 ITA] broadly provides for individuals to be treated as not resident in the UK if they are here "for some temporary purpose only and not with any view or intent of establishing ... residence there", and have not actually spent six months here in the relevant tax year.[50] Case law has indicated that all the facts and circumstances of a case must be considered, and not merely the number of days spent in the UK. We consider that individuals who have a UK-based employment or business, have strong ties with the UK and spend a sufficient amount of time in the UK in a tax year are unlikely to be able to show that they are in the UK for only the "temporary purpose" specified in the statute.[51]

The Bulletin then makes the usual reservation and qualification:

> 7. In dealing with claims to not resident status from mobile workers who usually live in the UK and make frequent trips abroad, we will apply the law in the light of the facts and circumstances of the particular case. For the reasons considered in this note, it is likely in our view that such claims will probably be invalid on the facts. Nevertheless, taxpayers who disagree with our view that they are UK resident will have the usual right to appeal to the Commissioners. It should moreover be borne

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50 [Footnote original] This is the wording of Section 336(1) ICTA in relation to Schedule D. Section 336(2) ICTA in relation to Cases I, II and III of Schedule E refers to an individual who is in the UK "for some temporary purpose only and not with the intention of establishing his residence there".

51 [Author's Note] This is still referring to workers commuting from the UK not those based from outside. See paragraph 1 of the statement.

> in mind that these guidelines are general. We accept that it might be possible for individual taxpayers to show that not resident status was correct on the facts of their particular case.

4.18.2 *Mobile workers and the three-years-abroad practice*

Although mobile workers cannot usually rely on the full-time work abroad practice, can they rely on the three-years-abroad practice? Then it is not a requirement that they work full-time abroad! The Tax Bulletin felt no need to address the issue:

> **Mobile workers leaving the UK permanently**
> 8. This note is concerned with the residence status of mobile workers who usually live in the UK and have not genuinely left this country. Different considerations apply to those who have left the UK to live abroad permanently. Paragraphs 2.7-2.9 of booklet IR20 explain the circumstances in which such individuals may be treated as not resident and not ordinarily resident. Their return visits to the UK since leaving must have totalled less than 183 days in any tax year, and have averaged less than 91 days a tax year over the period of absence up to a maximum of four years; and they may be required to provide evidence that they have left the UK permanently, or to live outside the UK for three years or more. This group is otherwise outside the scope of this note ...

But in the light of Brief 1/07 we can see that reliance on the three years abroad practice will also fail on the requirement to genuinely “leave” the UK.

Mobile workers are a significant part of the economy and one can see why HMRC want to treat them as resident. HMRC are also entitled to do this as a matter of law.[52] However, the correct way to proceed would have been to amend IR20, not to leave it in its current form, where no one who reads it (unaided by Tax Bulletin 52 and Brief 01/07) would think of reading it in the manner that HMRC now do. This would admit (which Tax Bulletin 52 conceals) that we have seen a significant change of HMRC attitude on the point. It would also raise issues of transitional relief which HMRC would rather not address.

The Bulletin concludes with a point which goes without saying:

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52 See 4.17 (Requirement to “leave” the UK).

9. We have recently encountered cases where mobile workers claim to have gone abroad permanently, but evidence has later emerged that the validity of these claims is in doubt. In such cases we may at the outset have allowed not resident status, accepting the claims in good faith on the facts available at the time; but we have later concluded that the individuals may not have disclosed all the relevant information. The fact that such claims may initially have been accepted will not of course prevent us reopening cases where we have reason to believe there may not have been a full and correct disclosure. Where it is established that claims of this sort are invalid, the individuals will then fall to be treated as resident and ordinarily resident in the UK, as explained earlier in this note, on the basis that they do in fact usually live in the UK.

4.19 "Date of departure", "visits"

The full-time work abroad practice and the three-years-abroad practice assume:

(1) one can identify the date when a person "leaves" the UK as a date of "departure"; and

(2) subsequent time spent in the UK constitutes "visits" to the UK.

Example 1

Suppose T is continually present in the UK until 1 May 2004. T then leaves for several years and averages less than 91 days in the UK.

Since T "left" on 1 May 2004, T is resident in 2004/5 even though spending less than 91 days here in that year. The period of residence 6 April to 1 May 2004 is not a "visit". The year 2004/5 may qualify for year of departure treatment: see 6.3 (Concession A11).

Example 2

By contrast, suppose T "left" on 6 April and returned for a three week visit on 1 May. T spends exactly the same number of days in the UK as in example 1, but he will be non-resident throughout 2004/5.

It is essential to identify a date of departure. This may be difficult if T is UK resident because he averages more than 91 days here (but much less than the whole year), and then the pattern changes and he averages less than 91 days. In that case one cannot identify an obvious date of departure. It may be that all the time spent here should be regarded as "visits" and every period of absence is a potential date of departure. But this is the sort of case where HMRC may say that the individual has not met the requirement to "leave" the UK.

4.20 Calculating annual average visits

This calculation is carried out in the same way for:

(1) the full-time work abroad practice;

(2) the accompanying spouse concession; or

(3) the three-years-abroad practice.

4.20.1 *Illness and exceptional circumstances*

IR20 provides in each place in the same words:

> Any days spent in the UK because of exceptional circumstances beyond your control, for example the illness of yourself or a member of your immediate family, 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 paragraph 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 paragraph 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 would have to be classified as a concession, not simply as an HMRC practice. But the 183 day rule can therefore operate very harshly.

4.20.2 *Days of arrival and departure*

IR20 para. 1.2 states:

> The normal rule is that days of arrival in and departure from the UK are ignored in counting the days spent in the UK, in all the various cases

> where calculations have to be made to determine your residence position – see for example paragraphs 2.2, 3.3 and 3.4 and the examples in 2.10 and 3.6. (This rule is not relevant to the concessionary split year treatment described in paragraphs 1.5–1.6, where a person coming to or leaving the UK part way through a tax year is resident from the date of arrival or to the date of departure.)[53]

The problem here is the word "normal". It suggests one should count days of arrival and departure in some circumstances; if so, in which circumstances? The second sentence in para 1.2 (dealing with split years) is clearly one exception. On one reading this could be taken to be the only exception. The alternative view is that there can be other cases where the "normal" rule does not apply. There is some evidence that HMRC practice was formerly to disregard all days of arrival and departure (except for the split year concession).[54]

In the 5th edition of this book I commented: "This is not sufficient to bind HMRC and they could disapply the normal rule in 'abnormal' cases." This has now happened: HMRC are pushing at the boundaries of IR20 in order to bring more individuals within the scope of UK tax.

What is "abnormal"? Because of HMRC's apparent change of practice, this is now a central question, however odd it may seem. One might think that an example is an individual who commutes to the UK, e.g. arriving every Monday morning and leaving every Wednesday evening; the individual may be present in the UK for 150 days but excluding arrival and departure reduces this to 50. This is not a normal lifestyle, so it seems a case where the "normal" rule should be disapplied. If, as appears, HMRC now take the point, where does the dividing line come? What if an individual has (say) 60 days of arrival and departure? Or 40? In

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53 See 6.3 (Concession A11).

54 The Consultative Document, Residence in the UK (1988) provided:

> "4.5 When an individual arrives in or leaves this country, that day is not counted in calculating the time he has spent here in that particular year. This practice is more generous than the law requires particularly for people making a lot of short visits. At the extreme it is possible for an individual to be in the UK on every day of the year and not be treated as resident so long as he is absent for a few hours on at least half of them."

The Inspectors Manual para. 50 also provides without qualification that "days of arrival and departure should be excluded on the occasion of each visit". The same point is made in EI Manual para. 42840.

current times, I think that 40 days of arrive and departure are by no means unusual. Is this a matter on which a Court would be prepared to hear evidence, or would a judge simply form his or her own view? It is suggested that a reasonable point to draw the line at would be visits of less than one a week, i.e., less than 50 UK visits a year is normal but more is abnormal.

If the normal rule is not applied, does one count all the days of arrival and departure towards the 91 days? Or only some? Or does one count hours present in the UK? This issue arose in the context of the 183 day rule, where the Court's answer was to count hours present in days of arrival and departure.[55] The drawback with this solution is that it is not realistic to expect records to be preserved. An alternative, now supported by the Special Commissioners,[56] is to count the days of arrival and departure as one day. It is suggested that the former is the best solution in the context of the 91 day rule, though since that rule is not statutory, it would be difficult to persuade HMRC if they disagree. In practice the two approaches will normally lead to the same result.

Modern travel patterns have made this common, and it is scandalous that the position is unclear; but so it is.

The disregard applies to the 183 day rule as well as the 91 day rule, and in that context it is strictly a concession, for the law is that one counts hours present in days of arrival and departure in order to apply the 183 day rule. But cases in which it actually matters must be very rare.

4.20.3 *Method of calculating average*

IR20 states:

> 2.8 ... The average is taken over the period of absence up to a maximum of four years – see paragraph 2.10...
> 2.10 If it is necessary to calculate your annual average visits to the UK, the method is as follows:
>
> $$\frac{\text{Total visits to the UK (in days)}}{\text{Total period since leaving (in days)}} \times 365 = \text{annual average visits}$$

55 *Wilkie v IRC* 32 TC 495.

56 See 4.20.4 (The law).

> For this purpose, days spent in the UK in the tax year before the date of your original departure are excluded.
>
> Suppose, for example, you leave the UK on 5 October 1997. The first review of the average of your visits is made after 5 April 1999, and takes account of your visits between those two dates. If you visited the UK for 30 days between 6 October 1997 and 5 April 1998 and for 50 days in 1998–99, the annual average is
>
> [(30 + 50)/(182+365)] x 365 = 53.38 days
>
> If you continue to remain outside the UK, the annual average is calculated as follows in reviews after 5 April in subsequent years
> - after 5 April 2000 – include visits from 5 October 1997 to 5 April 2000
> - after 5 April 2001 – include visits from 5 October 1997 to 5 April 2001
> - after 5 April 2002 – include visits from 6 April 1998 to 5 April 2002.
>
> After the third review the year of departure is dropped from the calculation. At each subsequent review the oldest year is dropped, so that there is a rolling period of four years being reviewed.

So far this is completely clear. IR20 now injects a note of uncertainty:

> However, if during your absence the pattern of your visits varied substantially year by year, it might be appropriate to look at the absence as being made up of separate periods for the purpose of calculating average visits. This might be necessary if, for example, a shift in the pattern of your visits suggested a change of circumstances, which altered how we viewed your residence status.

IR20 gives no illustration of how this operates. Probably no-one takes any notice of it in practice, though that could change.

4.20.4 *The law*

According to IR20 the number of days spent in the UK is (in many cases) determinative. To ascertain the exact number is often crucial. In law, by contrast, time spent in the UK (up to 183 days) is merely a factor to be taken into account.[57] So the question of exactly how one calculates days spent in the UK is less important. 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 IR20 principles) if the taxpayer stayed overnight;

(2) counted days spent in the UK due to illness (contrary to IR20 principles).

It is submitted 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.

4.21 Coming to the UK

We turn from Chapter 2 of IR20 (Leaving the UK) to Chapter 3 (Coming to the UK). The chapter is somewhat confused.

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

(a) the three years in the UK practice;

(b) visitors to the UK, not within (a), a category divided into:

    (i) short-term visitors:

        [A] indecisive visitors;

        [B] intentional visitors;

    (ii) longer term visitors.

4.22 The three years in the UK practice

IR20 provides:

57 See 4.8 (Case law).

3 Coming to the UK
Coming to the UK permanently or indefinitely
3.1 You are treated as **resident and ordinarily resident** from the date you arrive if your home has been abroad and you intend:
[1] to come to the UK to live here **permanently**, or
[2] to come and remain here for three years or more.

(Emphasis original but paragraph numbering added)

Limb [1] refers to those who "come to live here". Limb [2] refers to those who "come and remain here". Perhaps this means the same thing, so limb [2] covers just about everyone in limb [1].[58] Perhaps there is a slight difference in nuance, i.e. someone who comes to live in the UK permanently may not "remain" in the UK. In practice this is not likely to matter.

The IR20 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". This is roughly the converse of the three-years-abroad practice.

4.22.1 *Meaning of "remain"*

IR20 para. 3.1 provides:

> You 'remain' in the UK if you are here on a continuing basis and any departures are for holidays or short business trips. (The same applies for the other references in this Chapter to 'remaining' in the UK.)

A person who "comes and remains" in the UK in the IR20 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[59] and departure[60] (because

58 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).

59 Because someone who arrives after September will not be UK resident in the year of arrival under the 183 day rule alone.

60 Because someone who leaves before September will not be UK resident in the year of departure under the 183 day rule alone.

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.

4.23 Visitors: short term and longer term

IR20 provides:

> **Visitors to the UK**
> 3.2 If you come to the UK other than to live here permanently as in paragraph 3.1, the guidelines in the rest of this Chapter will govern your residence and ordinary residence position in the UK.
> The Chapter deals in turn with two main groups coming to this country—
> [1] short term visitors (where you visit the UK for only limited periods in one or more tax years, without any intention to remain for an extended period);
> [2] longer term visitors (where you come to the UK intending to remain indefinitely or for an extended period, perhaps stretching over several tax years).
> You may at first fall within one of these categories and later move to the other, depending on your precise circumstances.

I adopt these labels and refer to "short term" and "longer term" visitors. "Visitors", I think, are those outside IR20 3.1 (that is, they do not intend to "remain" in the UK (in the IR20 sense) for three years, or to live here permanently).

4.24 Short term visitors

There are two categories of short term visitors.

4.24.1 *Indecisive visitors*

IR20 continues:

> **Short term visitors – residence**
> 3.3 You will be treated as **resident** for a tax year if
> [a] you are in the UK for 183 days or more in the tax year (see paragraph 1.2), or

This is straightforward.[61]

> [b] you visit the UK regularly and after four tax years your visits during those years average 91 days or more a tax year – see paragraph 3.6. You are treated as resident from the fifth year.

I refer to those within [b] 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. Indecisive visitors are treated as UK resident from the beginning of the fifth year. The split year concessions do not apply in the fifth year.[62]

4.24.2 *Intentional visitors*

IR20 continues:

> However ...
> (ii) you are treated as resident from 6 April of the first year, if it is clear when you first come to the UK that you **intend** making such visits[63] and you actually carry out your intention; and
> (iii) you are treated as resident from 6 April of the tax year in which you **decide** that you will make such visits, where this decision is made before the start of the fifth tax year and you actually carry out your decision.

I refer to those who fall in this category as "intentional visitors". This category seems again[64] to have the status of provisional and uncertain residence. Suppose T intends to average more than 90 days here over five

61 See 4.10 (The 183 day rule).
62 See 6.4.2 (Habitual visitors)..
63 i.e. visits averaging 91 days or more a tax year.
64 See 4.16 (Three-years-abroad practice).

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 he unexpectedly changes his intention and leaves the UK, he retrospectively finds that he is not resident in years 1, 2 and 3 after all! (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 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).

IR20 continues with some straightforward examples:

> For example
>
> - you come to the UK with no definite intentions, but your visits during the tax years 1999–2000 to 2002–2003 average at least 91 days a tax year; you are resident from 6 April 2003.
> - you first come to the UK during 1999–2000, intending that between then and 5 April 2003 your visits will average at least 91 days a tax year; you are resident from 6 April 1999, provided that your visits in fact reach that level.
> - you first come to the UK during 1999–2000 with no definite intentions and you spend, say, 60 days here; you come again during 2000–2001 and decide you will come regularly in future years and your visits will average at least 91 days a tax year; you are resident from 6 April 2000, provided that your visits in fact reach that level.

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

The Inspectors Manual provides 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 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 IR20, though there is a hint of it in para 3.3[b] ("you visit the UK *regularly* ...").

4.24.4 *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[65] and outside it.[66]

4.24.5 *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. IR20 provides at 3.3(i):

> any days spent in the UK for exceptional circumstances beyond your control, for example the illness of yourself or a member of your immediate family, are not counted for this purpose.

This contrasts with the practice in relation to those leaving the UK where the word "normally" is added: see 4.20.1 (Illness and exceptional circumstances). *Quære* whether this is accidental or deliberate? IR20 also states:

> 3.6 Where it is necessary to calculate your annual average visits, the method is as follows:
>
> $$\frac{\text{Total visits to the UK (in days)}}{\text{Relevant tax years (in days)}} \times 365 = \text{annual average visits}$$

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65 This is consistent with the rule that even an illegal immigrant may be UK domiciled: see 3.13 (Refugees & illegal immigrants).

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

For example, suppose you visited the UK for 80 days in 1995–96, 100 days in 1996–97, 85 days in 1997–98 and 105 days in 1998–99. The annual average is

$$\frac{80+100+85+105}{366+365+365+365} \times 365 = 92.44 \text{ days}$$

4.24.6 *Short term visitors: ordinary residence*

The same short term visitors rules govern ordinary residence. IR20 provides:

Ordinary residence

3.4 You will be treated as **ordinarily resident** if you come to the UK regularly and your visits average 91 days or more a tax year – see paragraph 3.6. Any days spent in the UK for exceptional circumstances beyond your control, for example the illness of yourself or a member of your immediate family, are not normally counted for this purpose.

3.5 The date from which you are treated as ordinarily resident depends upon your intentions and whether you actually carry them out. You will be ordinarily resident

- from 6 April of the tax year of your first arrival, if it is clear when you first come here that you intend visiting the UK regularly for at least four tax years
- from 6 April of the fifth tax year after you have visited the UK over four years, if you originally came with no definite plans about the number of years you will visit
- from 6 April of the tax year in which you decide you will be visiting the UK regularly, if that decision is made before the start of the fifth tax year.

For example

- you first come to the UK during 1999–2000, you intend visiting regularly until at least 5 April 2003 and your visits will average at least 91 days a tax year. You are ordinarily resident from 6 April 1999.
- you come to the UK with no definite intentions, but you visit regularly during the tax years 1999–2000 to 2002–2003 and your

visits average at least 91 days a tax year. You are ordinarily resident from 6 April 2003.

- you first come to the UK during 1999–2000 with no definite intentions; you come again in 2000–2001 and 2001–2002 and during 2001–2002 you decide you will come regularly in future years, and your visits will average at least 91 days a tax year. You are ordinarily resident from 6 April 2001.

4.25 Longer term visitors practice

IR20 continues:

> **Longer term visitors – residence**
> 3.7 You are treated as **resident** in the UK from the day you arrive to the day you leave (see paragraphs 1.5, 1.6) if you come to the UK for a purpose (for example, employment) that will mean you remain here for at least two years.

I refer to this as the "longer term visitors practice" though the label is not entirely accurate.

This category overlaps unhappily with the three years in the UK practice.[67] A person who intends to remain *three* years is in that category.

A person who only intends to remain *two* years is in this category. A person who "remains" in the UK (in the IR20 sense)[68] for two whole years will be present in the UK during three tax years.[69] During the middle tax year the person will satisfy the 183 day rule. The relevance of the longer term visitors 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.

The longer term visitors 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

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67 See 4.22 (Three years in the UK practice)

68 See 4.22.1 (Meaning of "remain").

69 Unless the person arrives on 6th April and leaves two years later on 5th April.

see how anyone could come and remain in the UK without having a purpose, so this does not add anything.

IR20 continues:

> The same treatment will apply if you own or lease accommodation in the UK in the year you arrive here (see paragraph 3.11(a)).
> In all other cases you will be treated as resident for the tax year if
> - you spend 183 days or more in the UK in the tax year, or
> - you own or lease accommodation in the UK (see paragraph 3.11(b)).

At first sight this is alarming. Does a person become resident just because he owns or leases accommodation? But this comment refers only to those who come to the UK intending to "remain" here in the IR20 sense (i.e. on a continuing basis not leaving the UK except for short holidays or business trips).[70] This might be satisfied if the intention is to remain for a year (like Dave Clark in the USA) but not for less. I take "you own" literally.[71] This condition is not satisfied if a trust, company or spouse owns the property.

4.26 Visitors: ordinary residence

IR20 provides:

> **Longer term visitors – ordinary residence**
> 3.8 You will be treated as ordinarily resident in the UK from the date you arrive, whether to work here or not, if it is clear that you intend to stay for at least three years.

This repeats the three years in the UK practice.[72] After a passing reference to students,[73] IR20 turns to the ordinary residence status of indecisive visitors:

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70 See 4.22.1 (Meaning of "remain")

71 This is consistent with the reference to IR20 para. 3.11 (relating to ordinary residence).

72 See 4.22 (The three years in the UK practice). I take "intend to stay" to mean the same as "intend to come and remain" in IR20 3.1[2].

73 "If you come to the UK **as a student** for an extended period of study or education, see paragraph 3.13." See 4.26.1 (Students).

> 3.9 You will be treated as ordinarily resident from the beginning of the tax year after the third anniversary of your arrival if you come to, and remain in, the UK, but you
> - do not originally intend to stay for at least three years, and
> - do not buy accommodation or acquire it on a lease of three years or more.
>
> For example, if you arrive in the UK on 21 November 1999 and are still living in the UK on 6 April 2003, you are ordinarily resident from 6 April 2003.

IR20 then considers those who change their minds:

> 3.10 If, after you have come to the UK, you **decide** to stay for at least **three years** from the date of your original arrival, you will be treated as ordinarily resident from—
> - the day you arrive if your decision is made in the year of arrival, or
> - the beginning of the tax year in which you make your decision when this is after the year of arrival.
>
> For example—
> - you arrive in the UK on 4 January 2000 and decide on 16 May 2000 to stay permanently. You are ordinarily resident from 6 April 2000;
> - you come to the UK to work on 14 July 1999 on a 2½ year contract of employment, but in December 2001 your assignment is changed and your contract is extended until after July 2002*. You are ordinarily resident from 6 April 2001.

The asterisk refers to this text:

> * If there is a change in the circumstances of your assignment, but no formal change to the terms of a contract, whether you are treated as ordinarily resident and from what date will depend on the precise facts.

A little commonsense is needed here. For example, suppose a person comes for a two year project, the project falls behind and is expected to last three years, but later there is a catch-up and the project finishes in time after all. One cannot dip in and out of ordinary resident status according to the vicissitudes of the work schedule alone.

Accommodation can make all the difference for ordinary residence:

> 3.11 If you come to, and remain in, the UK, you will be treated as ordinarily resident
> (a) from the day you arrive, if —
> (i) you already own accommodation here
> (ii) you buy accommodation during the tax year of arrival, or
> (iii) you have or acquire accommodation on a lease of three years or more during the tax year of arrival; or
> (b) from 6 April of the tax year in which such accommodation becomes available, when this occurs after the year of arrival.
>
> 3.12 If you are treated as ordinarily resident **solely** because you have accommodation here (paragraph 3.11) and you dispose of the accommodation and leave the UK within three years of your arrival, you may be treated as not ordinarily resident for the duration of your stay if this is to your advantage.[74]

4.26.1 *Students*

The IR20 residence rules are almost the same for students, but there is an exception for ordinary residence:

> 3.13 If you are a **student** who comes to the UK for a period of study or education and you will be here for less than four years, you will be treated as not ordinarily resident, providing—
> - you do not own or buy accommodation here, or acquire it on a lease of three years or more, and
> - on leaving the UK you do not plan to return regularly for visits which average 91 days or more a tax year.

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.

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74 In this case the individual is provisionally non-ordinarily resident and will not know for certain whether he will be non-resident for up to three years. The words "if this is to your advantage" are puzzling because I cannot think of a case where it would be to the individual's advantage to be ordinarily resident in the UK.

4.27 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. This is outside the scope of this book.

4.28 HMRC forms and rulings[75]

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

75 See 3.14 (HMRC rulings on domicile and ordinary residence).

> 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.

Double Taxation Relief Manual 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.

4.29 Avoiding acquiring UK residence: practical advice

The sensible advice must be to accept the constraints of HMRC's practice. A non-resident individual who wishes to avoid acquiring the status of UK residence must:

(1) Spend less than 183 days here in any tax year, and

(2) Spend less than 91 days in the UK over a four year average.

It would be wise to retain evidence to be able to show dates of arrival and departure in case a challenge is made.

An individual who is unable to accept these restrictions should proceed on the basis that he will almost certainly be regarded by HMRC as resident in the UK. Rather than challenging HMRC's settled policy in this area he would be better advised to plan his affairs accordingly.

4.30 Losing UK residence: practical advice

A UK resident individual who wishes to lose UK resident and ordinarily resident status should take one of these courses:

(1) The full-time work abroad practice (one year's absence, full-time work abroad, less than 91 days spent in UK).

(2) The three-years-abroad practice (three years' absence) and "leave" the UK.

(3) The approach of *Reed v Clark*: one year's absence, base abroad, no (or next to no) time spent in UK.

4.31 Is IR20 correct in law?

The 1955 Royal Commission expresses the matter with tact. It summarises what is now IR20 and continues:

> These working principles are not statutory. It is claimed that they are proper deductions from the few statutory rules that do exist and from decided cases. We cannot give any positive confirmation of this claim, and we think that Appeal Commissioners at any rate might be in much the same difficulty.[76]

The Special Commissioners are more blunt:

> In this appeal we must apply the law rather than the provisions of IR20.[77]

In fact it is perfectly clear that the 91 day tests in IR20 are not consistent with the law.
A taxpayer *might* get a better result than IR20 allows by appealing to Commissioners who will have to try to apply the law. But do not expect it except in special cases. More importantly, on occasion, HMRC may try

76 Royal Commission on the Taxation of Profits and Income Final Report Cmd 9474 para. 291.

77 *Gaines-Cooper v HMRC* at [99]. Likewise *Reed v Clark* 58 TC 528 at p.556: "I do not see how this booklet [IR20] affects any matter which I have to decide."

to reach a better result than IR20 allows by ignoring what it says. But in principle the taxpayer has the remedy of judicial review in such a case. IR20 paragraph 1.1 provides:

> This booklet sets out the main factors that are taken into account, but we can only make a decision on your residence status on the facts in your particular case.

Likewise the preface to IR20 provides:

> You should bear in mind that the booklet offers general guidance on how the rules apply, but whether the guidance is appropriate in a particular case will depend on all the facts of that case.

But this does not give HMRC *carte blanche* to disregard IR20 whenever it suits them to do so.

4.31.1 *The future*

There appears to be an HMRC campaign to bring more people into the charge to tax as UK residents. This began with the tax bulletin statement on mobile workers, and has continued with the recent cases on residence, *Shepherd* and *Gaines-Cooper*. Perhaps the next step will be to revise IR20. (That could raise interesting issues of transitional relief. I expect that changes will be categorised as "clarifications" and the thorny issue of transitional rules can then be ignored.) But this is a matter of speculation.

4.32 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[78] of tax. Likewise with ordinary residence.[79]

78 As to whether "avoidance" is the right term to use here, see 19.8 (Avoidance/mitigation).

79 58 TC 528 at 556.

The preface to IR20 states:

> Some practices explained in this booklet are concessions made by the Revenue. A concession will not be given in any case where an attempt is made to use it for tax avoidance. Where the booklet mentions a concession, the reference given (for example "Concession A11") is the number of the concession in booklet IR1 "Extra-statutory concessions", which provides further details.

I take this to refer only to the concessions labelled as such in IR20: concessions A10, A11, A27, A78, D2. Practices in IR20 not identified as "concessions" cannot be disapplied in cases of tax avoidance.

4.33 Summary

The following summary of HMRC practices is an over-simplification but may assist as a checklist:

Leaving the UK practices	**Resident**	**Ordinarily Resident**
183 days in UK	yes	yes unless other rule applies
Full-time work abroad	no	no
3 years abroad	no	no
Year out	no	no (but may be disputed)
Coming to the UK practices		
183 days in UK	yes	no unless other rule applies
3 years in UK	yes	yes (unless student)
Indecisive visitor	no until 5th year	no until 5th year
Intentional visitor	yes	yes (unless student)
Longer term visitor (2 years)	yes	no (unless owns accommodation)

4.34 Commentary

4.34.1 *Residence and the rule of law*

There are several objections to the current practice as set out in IR20. The first is constitutional: the rules in IR20 have only a tenuous connection with the law declared by Parliament and applied in the Courts. One consequence is that appeals to the Courts are made very difficult. The second objection is that some aspects of the rules (for instance days of arrival and departure) are unnecessarily and unacceptably vague. The third is that some rules envisage a conditional or uncertain residence status under which an individual cannot know whether he is resident until up to four years later.[80] That is unworkable (or would be unworkable if taken seriously). The current state of affairs (one cannot properly call it the current state of the law) would not disgrace a banana republic.

The 1936 Codification Committee thought this state of affairs was "intolerable". The 1955 Royal Commission recommended reform.[81] The ill-fated 1988 Consultation Document (Residence in the UK) made proposals.

The obstacles to reform seems to be as follows. First, no-one can agree exactly what the residence test should be. 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. The *soi disant* review of foreign domicile taxation might have grasped this nettle but that now seems unlikely.

Thirdly, the current concept of residence is much wider than in many other countries. The absence of a proper definition tends to conceal that fact. To enact something along the lines of the current 91 day tests may cause some international embarrassment. But to enact anything closer to a 183 day test would allow more individuals to become non-resident and so may constitute an expensive reform. Indeed, even to enact the IR20 91 day tests would cost tax, if the current HMRC campaign to resile from IR20 proves to be successful, though the outcome at present is very doubtful. Until recently, the current system seemed to creak along just about well enough in practice, even if it fell short of any conception of the Rule of Law. But now that HMRC are seeking to expand the numbers within the scope of UK residence, this has ceased to be the case.

4.34.2 *Commentary: Should we abolish ordinary residence?*

The concept of ordinary residence is of almost negligible relevance to tax

80 See 4.16 (Evidence of intention to leave).

81 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*.

and there have been calls for its abolition.[82] Abolition would be a significant 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.

4.35 Residence of trusts and companies

For residence of trusts, see the next chapter.

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. 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" [2007] Jersey & Guernsey Law Review 153 (John Chadwick). 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).

4.36 Residence of partnership

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 ...

But current UK tax law does not use the concept of residence of partnerships, so the section was repealed. This raises a problem for the Channel Islands and IOM DTTs, which do refer to residence. For example, article 2(1) of the Jersey treaty provides:

> The terms "resident of the UK" and "resident of Jersey" mean

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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.

> 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.[83] 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.[84]

83 *Padmore v IRC* 62 TC 352.
84 See 12.28 (Partnership income: remittance basis).

CHAPTER FIVE

RESIDENCE OF TRUSTEES

5.1 Why does trust[1] residence matter?

Trustee residence (like individual residence) is fundamental for many tax purposes, of which the most important are:

(1) Income tax on foreign income (which applies to UK resident discretionary[2] trusts).

(2) Capital gains tax.

5.2 Definition of trustee residence

From 2007/8 there is one main[3] definition of trustee residence, which is the same for income tax and CGT.

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.

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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 The charge applies only in a very attenuated form to interest in possession trusts.

3 There is a separate definition of trustee residence for s.218 IHTA: see 48.1 (Reporting requirements). The drafter of the IHT (Delivery of Accounts) (Excepted Settlements) Regulations 2002 (perhaps a beginner) chose to give another definition for settlements with a trust fund of less than £1,000.

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 2007/8 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 to speculate as to whether this is a true reason or an excuse. An application to the Information Tribunal under the Freedom of Information Act is pending. This should be resolved by the time of the 7th edition of this book, though damage to the UK trustee industry will by then be done.

5.3 Identifying trustees

One needs first of all to identify the trustees. This is normally but not invariably straightforward. See 5.14 (Protectors) 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

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

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 Chapter 4 (Residence of individuals).

5.4 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).

5.5 Trust 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. Section 69 TCGA provides:

> **69 Trustees of settlements**
> (1) For the purposes of this Act the trustees of a settlement shall, unless

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.

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

> 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 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.

5.6 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.

5.7 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).

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).

5.8 Condition C

Condition C corresponds to the CGT relevant time rules. 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.
> (2) 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.
> (3) 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 who is resident, ordinarily resident or domiciled in the UK.

(2) A "UK-linked trust" is one whose 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.

5.8.1 *Identifying settlor and date of provision: tainting*

In trusts with mixed resident trustees, it is sometimes necessary to identify the settlor[7] and to ascertain when property is provided.

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

Suppose a settlor has lent interest free to a trust, while abroad, and then comes to the UK and leaves the loan outstanding.[9] It is considered that the settlor has provided property by leaving the loan outstanding.[10]

5.9 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.

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7 See 45.1 (Who is the settlor?).

8 See 45.3.9 (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 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 45.13 (Provision of property for company held by trust).

10 See 45.19 (Failure to exercise rights of re-imbursement).

The consequences of a trust becoming UK resident will be disastrous for CGT.[11] 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.[12] 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 extreme unfairness, the problem will be ignored or overlooked by non-compliant taxpayers, and not spotted by anyone else.

5.10 Trustees change residence during the year

See 6.14 (Income tax on trustees).

5.11 Sub-funds

It is common for one trust to be divided into separate funds ("sub-funds"). Section 474 ITA provides:

> (2) If different parts of the settled property in relation to a settlement are vested in different bodies[13] of trustees, subsection (1) and sections 475 and 476 apply in relation to the different bodies as if they were all one body.
> (3) 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.[14]

Thus the trust is UK resident unless the sub-funds jointly meet both

11 It may not be disastrous for IT, because the trust may qualify for the remittance basis. See 9.6 (Remittance basis for trustees).

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

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

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

conditions 1 and 2 for non-residence. 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.[15] 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.

5.12 Transfer between settlements

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

> (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.

5.13 Trustee with UK permanent establishment

Section 475(6) ITA provides:[16]

15 HMRC correspondence to the author.
16 The CGT equivalent is s.69(2D) TCGA.

> 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 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.

A non-resident trustee falls into this trap if:

(1) it carries on business in the UK and acts as trustee in the course of that business. In short, the business must be (or include) trustee business.

(2) It does so through a branch, agency or PE.[17]

5.13.1 *"In the course of 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 any business. This may offer a solution to the PE problem.

17 For further discussion of these concepts, see 12.3 (Non-resident trader rules); 12.19 (Meaning of PE).

5.13.2 *"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, for this purpose, 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 business is carried on through a UK PE, the entire trust may become UK resident. This must be a restriction on freedom of establishment, and it is suggested that the rule would not survive a challenge under EU law. As to whether a business is partly carried on in the UK, see 12.3 (Non-resident trader rules).

5.13.3 *Branch/agency*

In tax, the concept PE is used for companies and "branch or agency" is used for individuals. 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]

5.13.4 *One trustee of several trusts*

What is the position if a person is trustee of several trusts and he acts as

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18 HMRC letter to STEP 8 January 2007 accessible to STEP members on *www.step.org/showarticle.pl?id=1791*.

19 See 12.26 (Meaning of "branch or agency").

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.

5.13.5 *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 5.7 (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 PE difficulty.

5.13.6 *When is there a UK PE?*

STEP asked HMRC to clarify this point and a statement of practice is now promised. 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]

20 See 12.20.2 (Time condition).

(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 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]

5.14 UK protector and trust residence

It is normal practice to appoint a "protector"[22] who has power:

(1) to consent to certain key matters of trust administration; and

(2) to appoint and dismiss trustees.

21 See 12.22 (PE: preparatory & auxiliary activities).
22 On trust law and drafting aspects of protectors, see *Drafting Trusts and Will Trusts*, James Kessler QC, Sweet & Maxwell, 8th ed, para. 7.29.

The protector may be a UK resident. A protector could not be regarded as a trustee[23] and so his actual residence is irrelevant in ascertaining the 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.

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23 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*, 16th edition, 2003, p.29, 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 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.

5.15 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 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.[24] But the mad anti-avoidance structure of sections 86 to 98 TCGA, bolstered (supposedly) by Schedules 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.

24 See 45.32 (Planning to create trust with foreign domiciled settlor).

CHAPTER SIX

YEAR OF ARRIVAL AND DEPARTURE

6.1 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. Exit taxes on emigration are considered in the next chapter. 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.

This is correct[1] but subject to two exceptions of such breadth that the general principle rarely applies:

(1) Relief is available by HMRC concession ESC A11.

(2) Relief may be available under Double Tax Treaties. These are

1 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).

important but reference will need to be made to each treaty and they are not individually discussed in this book.

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.

6.3.2 *Year of departure*

The usual conditions for year of departure treatment are:

- The individual must leave for permanent residence abroad: ESC [2](b).
- The individual must cease to be ordinarily resident in the UK: ESC [3][b].

Condition ESC [2](b) is stricter than the equivalent rule for the year of arrival, ESC [2](a). 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. 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.

This assumes that the individual is not ordinarily resident abroad in the year following the year of departure, but is that right? I would have said that he was ordinarily resident, until he changed his mind and decided to return. It is however an usual 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 ESC [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. How this is applied in practice is explained in the Manuals and IR20. Different rules apply to year of arrival and year of departure and different rules apply for the arising and the remittance bases.

6.4.1 *What is the period of residence?*

The first step is to ascertain "the period of residence here during the year". For this purpose the days of arrival and departure are counted.[2] Such days are normally disregarded and there is no good reason for the anomalous treatment here; but there it is. In practice it makes very little difference.

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2 See 4.20.2 (Days of arrival and departure).

There is no other guidance on how to ascertain the period of residence here. Clearly "residence" does not have its normal income tax meaning, for the individual is resident for the whole tax year; so what does residence mean?

	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

Here is just a selection of cases. 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 provides at 1664:

> **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)[3] 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 is a little difficult to follow now, because parts of it are out of date, discussing the preceding year basis (abolished 1996/7) and paying and collecting agents rules (abolished in 2000). I here set out the parts of the text which are still relevant, doing my best to disentangle them. IR20 provides:

> **Coming to the UK**
> 6.18 Paragraphs 6.19 and 6.20 apply for years ... after 5 April 1997. ...
> 6.19 For the tax year of your arrival, where you receive overseas investment income from which tax has not been deducted and you are not taxed on the remittance basis, the following rules apply—
> [a] you will not have to pay tax on income from a source which ceases before the date of your arrival;
> [b] where the source continues after your arrival, but ceases in the same tax year, you will only pay tax on the income arising from the date of your arrival to the date the source ceased;

[a] and [b] deal with the situation where the source ceases in the year of arrival. I find the rules surprising but taxpayers are not likely to complain. We then turn to the case where the source does not cease in the year of arrival:

> [c] where the source ceases in the tax year following the year of your arrival, you may be charged to tax for both years—
> [i] for the year of arrival, you will pay tax on the greater of—
> (a) the same fraction of your overseas investment income for the year of arrival as the fraction of the full tax year for which

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3 This passage in the Inspectors Manual set out the short term visitors rates. See 4.24 (Short term visitors).

you are resident in this country, and

(b) [for years before 6 April 1996 ...]

[ii] for the year following the year of arrival, you will pay tax on the overseas income arising from 6 April in that year to the date when the source ceased

[d] where the source continues to the end of the tax year of your arrival and beyond, and income first arose—

[i] in the tax year of your arrival but before you became resident here, or

[ii] [for years up to and including 1995–96...]

you will only pay tax on the same fraction of your total overseas income for the year of arrival as the fraction of the full tax year for which you are resident in this country.[4]

[c] and [d] are in effect the same. The Inspectors Manual para. 1663 provides (so far as relevant):

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

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4 IR20 then gives an example which relates to 1993/4 but that involves the preceding year basis (happily now repealed):

"Suppose, for example, you come to the UK on 6 August 1993, and are resident for the rest of the tax year of your arrival (ending 5 April 1994). Your investment income continues beyond 5 April 1994, and first arose at some time between 6 April 1992 and 5 August 1993 (that is, in the tax year 1992–93 or the first part of the year of your arrival). You are resident for 8 months during 1993–94, and are therefore taxed on 8/12 of the whole of your investment income for that year

– for years up to and including 1995–96 where the source continued as in the previous example, but income first arose earlier than the tax year before the year of your arrival, the fraction of income on which tax was chargeable was worked out in the same way as in the previous example, but the income in question was that of the year before the year of your arrival if the source was in existence at 5 April 1994.

Suppose the facts are as in the previous example, but your investment income first arose before 6 April 1992. You are taxed in the year of your arrival, 1993–94, on 8/12 of your investment income for the tax year 1992–93."

from the date of arrival to the following 5 April, of the full amount of income arising in the year of arrival.

This restates IR20 6.19[a] and [c] though it does not mention [b]. The Manual then gives an example which helpfully illustrates rule (2):

> 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 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. This applies to a foreign domiciliary if the arising basis applies, for instance, income from Ireland (which is, subject to the EU point, outside the remittance basis).

An alternative solution would have been to identify when the income arose and disregard pre-arrival income, but the Manual does not adopt that approach. It would perhaps have been more difficult to use (for sometimes it is not obvious exactly when income arises).

6.5.2 *RFI: remittance basis*

IR20 provides:

> 6.20 For the tax year of arrival, where you receive overseas investment income [*from which tax has not been deducted*][5] and you are taxed on the remittance basis (see paragraph 6.2), the following rules apply
> [a] you will not have to pay tax on overseas investment income you remit from a source which ceased before the date of your arrival (for example, a bank account which you have closed)

This is the same rule as for the arising basis. IR20 then considers the

5 Words in italics are now irrelevant as rules requiring paying and collecting agents to deduct tax from foreign income were repealed in 2000.

position where the source has not closed:

> [b] where the source continues after your arrival but ceases in the same tax year, you will pay tax on the lesser of—
> [i] the total overseas investment income that you remit to the UK in the year, and
> [ii] the overseas income arising from the date of your arrival to the date the source ceased
> [c] where the source ceases in the tax year following the year of your arrival, you may be charged to tax for both years—
> [i] for the year of arrival, you will pay tax on the lesser of—
> (a) the overseas investment income you remit to the UK in that year [*(if the source was already in existence at 5 April 1994, the income remitted to the UK in the previous year if this is greater)*][6], and
> (b) the same fraction of your total overseas income for the year of arrival [*(if the source was already in existence at 5 April 1994, the income remitted to the UK in the previous year if this is greater)*][7] as the fraction of the full tax year for which you are resident in this country
> [ii] for the year following the year of arrival, you will pay tax on the overseas income you remit to the UK in that year, but reduced if necessary so that the sum taxed for the two years does not exceed the total of—
> (a) an amount worked out on the lines of (b) above for the year of your arrival, and
> (b) the amount of income arising from 6 April in the following year up to the date the source ceased.

[b] and [c] are now effectively the same (this was not the case under the old preceding year basis). Inspectors Manual 1663 provides (so far as relevant)::

> **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.

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6 Words in italics are now irrelevant following abolition of the preceding year basis in 1996.

7 See above fn.

(1) No liability arises where the source of income ceases before permanent residence begins.
(2) Liability for the year of arrival should be based ...
(b) where the remittance basis applies, strictly upon the sums received in the UK in the whole of the year of arrival[8], but may be restricted to the amount which would have been chargeable if the arising basis had been applicable.
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 follows:–

30/6/97	£100
30/9/97	£200
31/12/97	£150
31/3/98	£250
[total	£700]

On 31 December 1997, £400 of this income is remitted to the UK.
If the remittance basis applies, the amount strictly chargeable is £400, [i.e. ignoring the concession] but in practice this may be restricted to £350.

This is not consistent with the ESC. 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.

The different practice for year of departure tends to confirm this.

6.5.3 *IT planning prior to coming to UK*

It would be desirable to arrange to receive and remit income in the tax year before arrival. One cannot avoid IT by arranging for income to

8 In strict law, certainly, liability is based on sums received in the UK in the whole of the year of arrival, but applying ESC A11 one might have thought that remittances before arrival should be ignored, or time apportionment applied.

accrue in the year of arrival before actual arrival; but one can avoid it by arranging that sources of income cease before residence begins. This should be done by selling the asset concerned. It could be done by a transfer to a trust or company[9], but then the concession might be withdrawn on the grounds of tax avoidance.

6.6 IT Computation in year of departure

6.6.1 *RFI: arising basis*

The method of computation for the year of departure is entirely different, and more generous, than for the year of arrival. IR20 provides:

> **Investment income of those who leave, or come to, the UK part way through a tax year**
> **Leaving the UK**
> 6.14 [This relates to paying and collecting agents, and is not now relevant]
> 6.15 For all other 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 (or, for years before 6 April 1997, ...) 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.

6.6.2 *RFI: remittance basis*

IR20 continues:

> 6.16 For overseas investment income where you are taxed on the remittance basis (see paragraph 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

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9 See 9.49 (Source-ceasing).

> in the year of departure (or, for years before 6 April 1997, ...) as the fraction of the full tax year for which you are resident in this country.

The Inspectors Manual provides:

> **1667. Persons ceasing to be resident in UK**
> Where a person (other than an individual of the type referred to in IM45)[10] 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—
> (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.

6.7 Employment income

6.7.1 *Pre-commencement and post-cessation earnings*

EIM 40006 provides:

> **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 United Kingdom. The same principle applies where the taxpayer takes up a new job on becoming resident in the United Kingdom.
> In some cases however the taxpayer may leave the job after ceasing to be resident in the United Kingdom. Equally the job might start before the taxpayer arrives in this country. In these circumstances it may be

10 See 6.4.2 (Habitual visitors).

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 United Kingdom. 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. ...

Example 1

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.

Section 17 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.

The result will be the same if the relevant charging provision is Section 21 because the employee is resident, ordinarily resident but not domiciled in the UK. However, Section 30 operates rather than Section 17 as the charging provision is in Part 2 Chapter 5.

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 United Kingdom. From the date of arrival he became resident and ordinarily resident.

6 months after the job ended 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 makes the payment earnings of the year in which the employment was last held, 2003/2004. In that year the employee was not resident in the United Kingdom 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.

6.7.2 *Employment-related securities*

The Employment-Related Securities Manual provides:

> **70460. Date of departure from UK and ESC A11 [December 2005]**
> 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 para 6.7 provides:

> 6.7 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.

This appears to operate concession A11 by reference to the date interest is payable, not by time apportionment. Or perhaps the rule that one must be resident for a whole of a year and not for part of a year does not apply to ordinary residence, in which case the concession is irrelevant to the FOTRA exemption.

6.9 Income within s.624 ITTOIA

The Manuals do not deal with this expressly, but ESC A11 is in general terms, so one computes liability by reference to the period of residence here and it must be assumed that the RFI rules set out above apply.

6.10 Income within s.720 and s.731 ITA

Perhaps one can split years by reference to ordinary residence.

6.11 UK source income

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.

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 such gains: see 21.2.2 (Individual non-resident in year of chargeable event). There is some sense in this, because policies already qualify for non-resident period relief.[11]

6.13 Accrued income scheme

IR20 provides:

> 6.9 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 (known as the 'accrued income scheme') normally apply when the securities are transferred. You are charged income tax on the interest that has built up 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.

11 See 21.2.3 (Non-resident period relief).

6.14 Income tax on trustees

If a trust changes residence by appointment of new trustees it is suggested that the tax year is split into UK and non-UK resident periods. This is the HMRC view, TSE Manual 1461:

> **Trustees' residence for income tax and capital gains tax purposes – periods from 6 April 2007** [November 2006]
> ...
> Changes in residence status
> For income tax purposes where the residence status of the trustees (the 'deemed person') changes during a tax year, the year is split. Where liability to UK income tax is affected by residence it is computed by reference to the period of the trustees' residence in the UK during the tax year.
> For CGT purposes, if the trustees are resident for any part of a tax year, gains arising at any time in the tax year are chargeable to CGT. The split year treatment does not apply. Where the trustees become non-resident during the year there may be an exit charge (see CG38350+).

HMRC do not argue that the introduction of the rule that trustees are a separate person for IT has altered the position. Where a trust migrates by the migration of a trustee in his personal capacity (without an appointment of new trustees) the position must be the same; but in practice this is rare.

6.15 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 the disposal of assets 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.

6.15.1 *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.[12]

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12 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

6.15.2 *Year of arrival*

The conditions for year of arrival treatment are:

- the individual comes to live in the UK: ESC 1.[a][i]

- the individual is treated as resident here from the date of arrival: ESC 1.[a][ii]

- the individual has not been resident at any time during the 5 years of assessment before the year of arrival: ESC 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.[13]

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.

6.15.3 *Year of departure*

The conditions for year of departure treatment are:

- the individual leaves the UK: ESC 2.[a][i]

- the individual is treated on departure as not resident: ESC 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: ESC 2.[b].

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a branch or agency."

This is consistent with the usual CGT rule for trades carried on through a branch or agency.

13 See 6.4.2 (Habitual visitors).

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 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; see 29.17.4 (Time limit for assessment).

6.16 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.[14] 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.

6.16.1 *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

14 See 29.4 (Date of disposal when remittance basis applies).

words of the concession and it is tentatively considered that this is correct. Solution (3) cannot be applied, since it imposes more tax than would be the case without the concession.

6.17 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[15] 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 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 the settlement – whether the trustees are resident or non-resident. 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 trust gains, and so may escape tax altogether. Though if the concessions were made statutory, this anomaly could easily be corrected.

6.18 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

15 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.

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 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.
25806–25819.
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?
25821–25829.
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.
25832–25849.

6.18.1 *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 United Kingdom 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 United Kingdom. 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.
25856–25859.
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.

6.18.2 *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.

...

6.18.3 *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."[16]

6.18.4 *Withholding the concession*

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

16 See 19.18.3 (Genuine).

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. Withholding benefit of ESC D2

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. Withholding benefit of ESC D2

If you are asked to explain the reasons for your enquiries you may point out to 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.

25987–26009.

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.

26011–26019.

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.

26021–26029.

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.
26031–26039.
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 United Kingdom.
26041–26049.
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 United Kingdom, 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.
26051–26059.
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 United Kingdom – 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.

6.19 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" (ie, 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.

6.19.1 *Appeal against withdrawal of concession*

There is no appeal to the Commissioners 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 almost 10 years 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.

6.20 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.

A better course, involving more work, may be to transfer assets to a non-resident trust.

Watch the pre-owned asset rules: see 43.1 (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.

6.21 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 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.

> (1) 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) 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) 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 paragraph (a) above is, and the condition in paragraph (b) above may be, satisfied.

Section 168(6) 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 2005/6.

(2) The exit charge is payable on 30 January 2007.

D cannot be assessed until 12 months later, 30 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) 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 the 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 paragraph (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(6) 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 paragraph (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) provides:

> (3) 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) provides:

> (4) 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[1]

Section 17 ITTOIA provides:

1 References in this section to a trade include a profession or vocation, since there is no difference between them.

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 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[2] provides:

> 2. EXIT TAXES: LEGAL FRAMEWORK
> 2.1. The decision of the ECJ in *de Lasteyrie*[3] 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 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

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2 "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.*

3 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.

> MS. The ECJ ruled in *de Lasteyrie* and in *N*[4] 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.
>
> 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. If the migration is to a member state, these cannot stand up to EU law.

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 which are comparable:

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4 Case C-470/04 *N v Inspecteur van de Belastningsdienst* Oost / kantoor Almelo, 7 September 2006.

> 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 .

It is difficult to see how the exit charge could stand on a trust's migration to another EU state.

7.7.3 *Exit charge on emigration of trust to EEA/EFTA state*

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
> 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.

7.7.4 *Exit charge on emigration of trust 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.

CHAPTER EIGHT

SAVINGS AND INVESTMENT INCOME

8.1 Classification of income

The old system of classifying income by Schedule and Case has been replaced by a new classification. 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).

This chapter considers savings and investment income, dealt with in Part 4 ITTOIA. 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?

8.2 Why does "capital *v* income" matter?

"Income tax is a tax on income." This slogan is less true now than when it was formulated in 1900; but the first question still remains: is a receipt "income" in the hands of the recipient? For references to "income" in tax legislation do not include capital receipts unless statute expressly so provides (which it often does). This issue arises often in the context of distributions from trusts and non-resident companies, where the income/capital distinction is a difficult one.

8.3 Why does source of income matter?

The identity of the source from which income has arisen is relevant:

(1) to identify the situs of the source;

(2) to apply the source-ceasing principle; see 9.49 (Source-ceasing principle);

(3) because different rules apply to income with different types of source.

There is no statutory definition of "source". The word is too basic to be usefully defined. The word has been paraphrased as "origin"[1] and "chief cause"[2] or "originating" cause but these generalities are of no practical assistance.

Section 368(3) ITTOIA (territorial scope) 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 explains this:

> 33. Subsections (1) and (2) are drafted in terms of the "source" of the income. Although section 18 of ICTA refers to profits or gains from "property", the usual statutory term elsewhere in the Income Tax Acts

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1 *Hart v Sangster* 37 TC 231 at 235.

2 *CIR v Philips' Gloeilampenfabrieken* [1955] NZLR 868.

and in case law for the same concept is "source" and this has been adopted as the more familiar and modern term.

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 judgement 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 .

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. Subsection (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.

ITTOIA EN Vol II para 1639 notes that there was originally no income tax charge on amounts which were not from a source, and explains:

1639. There were at that time 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* [1921] 2 AC 222, 8 TC 57).
>
> If the income tax had retained that ancient simplicity, it would be true to say that income could not be within the charge to tax unless there was a source within the charge and a person could not be within the charge unless he had a source of income within the charge. But that would be because of the nature of the income tax

> and not anything in the language of the definition.
> 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.

1640. Although the definition 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, 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.

8.4 Why does situs of source matter?

The question of situs (location) of an income source is important because:

(1) A non-resident is taxable on UK source income, not foreign source income.[3]

(2) Income must have a source outside the UK to qualify as RFI.[4]

(3) Double tax treaties; see "Treaty Problems Relating to Source" [1998] BTR 222.

Statute formerly used a variety of expressions[5] but now the expression "source outside the UK" is the standard term.

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3 See 8.6 (Territorial scope)

4 See 8.5 (Relevant foreign income).

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.

Different considerations naturally apply to locating the situs of different kinds of income.

In relation to income from intangible sources (e.g. shares, debts, trades, etc.), the law must somehow choose a connecting factor to link the source to a jurisdiction. In principle, it would not matter much 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 situs of an income source are different from the situs of asset rules for IHT, CGT and private international law; see 46.1 (Concept of situs).

8.5 Relevant foreign income

Relevant foreign income ("RFI") is the term used by ITTOIA to describe the category of income formerly charged 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.

Section 830(1) ITTOIA provides the definition:

> In this Act "relevant foreign income" means income which
> [1] arises from a source outside the UK and
> [2] is chargeable under any of provisions specified in subsection (2).

Subsection (2) sets out a long list, not repeated here. It includes almost all foreign income charged under ITTOIA, including in particular trading income, property income, interest and dividends. Employment income is governed by ITEPA and not RFI.

RFI status is important for:

(1) the RFI remittance basis;

(2) withholding tax.

8.6 Territorial scope

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.[6]

8.7 Income from non-UK resident companies

BN40 (21 March 2007) proposes further complications for individuals who receive less than £5,000 foreign dividends per year but this takes effect from 2008/9 and is not discussed here.
Section 402 ITTOIA imposes a charge to tax on dividends from non-UK 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:

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6 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, 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."

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.[7]

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. 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.

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7 The disapplied definition states:

> "'Income' includes amounts treated as income (whether expressly or by implication)."

8.7.1 *"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.

8.7.2 *"Distribution"*

What receipts from companies (other than dividends) are within the charge under s.687? For UK companies the charge is on "distributions" and the term is very elaborately defined. For non-UK 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 clearly represents the law: see *MacPherson v European Strategic Business Bureau* [2000] 2 BCLC 683 and *Clydebank Football Club v Steedman* [2002] SLT 109 at para. 75.

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.

8.7.3 *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 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. (His 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 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.703 ICTA may also need to be considered.

8.8 Distribution from a non-resident company: income or capital?[8]

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.

8.8.1 *The general principal*

Courtaulds Investments v Fleming 46 TC 111, at p.124 summarises the law as follows:

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8 See Law Commission Consultation Paper 175 (Capital and Income in Trusts, 2004) accessible on *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 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.

The HMRC view is set out in Inspectors Manual:

> **1610. Distributions/foreign cos: In cash**
> Published: 9/95
> ... [9] a cash distribution to its shareholders by a foreign company will normally be assessable under Case V, whether it is attributable to the undivided[10] profits or to the capital resources of the company (*CIR v Trustee of Joseph Reid* 30 TC 431). Where, however, cash —
> a) is distributed on the liquidation of the company (*CIR 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*

9 The omitted words refer to s.123 ICTA (repealed in 1996).

10 [Author's note] "Undivided" in this context is an old fashioned term for "undistributed".

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*. The Manual continues:

> Any claim that a distribution constitutes a return of capital within (a) or (b) above should be referred to Revenue Policy International, (Cases IV and V), Victory House, together with the documentary evidence submitted by the taxpayer. ...

I find this instruction surprising as most cases would not be contentious. I suspect it is often ignored in practice.

> **1613. Distributions/foreign cos: Not in cash: Release of assets**
> Published: 9/95
> Where a foreign company releases[11] 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 CIR* 16 TC 52; *Briggs v CIR* 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. As regards CGT, the recipient of the assets may be entitled to an adjustment of the cost to him of acquisition of the assets.[12]

The Manual considers separately:

(1) distributions of cash; and

(2) distributions of non-cash assets of the company

11 [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.

12 I am not sure what point is being made in the last sentence, but it does not matter.

but the principle is exactly the same.

8.8.2 *Stock option*

The Inspectors Manual continues:

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.

8.8.3 *Issue of shares or debentures*

The Inspectors Manual continues:

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 (*CIR v Blott*, 8 TC 101; *Whitmore v CIR* 10 TC 645; *CIR v Fisher's Executors*, 10 TC 302; *CIR v Wright* 11 TC 181). ...[13]
In cases where the distribution is not actually made in shares and the shareholder accepts cash from the company under an option given to

13 The omitted words relate to s.66 ICTA (preceding year basis) repealed in 1994.

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.

8.8.4 *Dividend re-investment plans*

The Inspectors Manual continues:

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 *CIR 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.

8.9 Income distribution from company: source and situs

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 situs rules for CGT, IHT and private international law. This rule is now statutory: s.383 ITTOIA imposes tax on distributions from UK resident companies.

8.10 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.

8.11 Open-ended investment companies

ITTOIA EN Vol II discusses the situs 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 paragraph 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.

8.12 Authorised unit trusts

See 25.2 (Authorised unit trusts).

8.13 Industrial & 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[14] 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.

8.14 Interest: charge and territorial limitations

Section 369(1) ITTOIA imposes the charge on interest:

> Income tax is charged on interest.

Section 368 ITTOIA provides the territorial limitation:

> (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.

14 [Author's note] See ss.379 and 83D(2) ITTOIA.

> (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. ...

ITTOIA EN Volume II paras. 33–36, which explain the background, are set out at 8.3 (Why does source of income matter?).

8.15 Interest: What is the source?

The source of interest from a bank deposit has been described as "the deposit of money on certain terms": *Hart v Sangster* 37 TC 231. In that case there was a substantial fresh deposit (£2m added to an account holding £20,000). This was a new source, even though the contract with the bank was one continuing contract (the payment of money into the bank does not bring about a new contract):

> I think it is argued here that the source of income was the contract. I cannot agree with that. I think the source of income here was the deposit of money upon the terms of the contract. In my opinion, if an addition is made to the amount which is deposited, the words of Section 21[15] are quite wide enough to catch it. I quite agree that certain difficulties might be imposed on the Inland Revenue if they were to pursue every deposit account and find whether or not there had been an addition to the account during the course of the year. That is a matter for the Inspector of Taxes or those responsible for the assessment to decide as to how they will deal with those matters. I do not suppose that in every case it would be worth the trouble that would be caused to the taxing authorities if they were to inquire into every deposit account and find if the interest had been increased, unless it had been increased by a large amount. Here, of course, the increase of £2,000,000 is very great. In my judgment there is no question but that there has been a source of income in the deposit of money, and at any rate there has been an addition to a source of income here.[16]

Thus it is held, obiter, that every payment into a bank account creates a new source. This was (as the Court realised) quite unworkable in practice.

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15 s.21 FA 1950 imposed a current year basis of assessment for the first two years of income from a new source.

16 37 TC at 237.

Now that the preceding year basis has (thankfully) been abolished, the important question is not when a new source arises but when an existing source ceases. Suppose:

(1) F holds £100 in a foreign account;

(2) F pays £100 into the foreign account (a new source, according to *Hart v Sangster*);

(3) F withdraws £100 from the account.

Arguably one applies a FIFO (first in first out) basis so that the second source has ceased. But then the law is so unworkable that a Court probably would (and in the author's view should) reject the obiter dicta in *Hart v Sangster*. It is suggested that, in the case of ordinary payments in and out, a bank account would be regarded as one single continuing source. It ceases to exist when the account is closed. There is arguably a cessation of a source at the time when an account is overdrawn. In order to be sure that an existing source has ceased, it would be preferable to close the old account and transfer the money to a new account at a new bank.

8.16 Interest: where is the source?

Foreign source interest is outside the scope of withholding tax[17] and within the scope of the RFI remittance basis.

I refer to the person paying interest as the payor and the recipient as the creditor.

The statute gives virtually no guidance on the situs of a source of interest, so one falls back on principle, case law and HMRC guidance.

8.16.1 *Principle*

Principle cannot identify the "right" connecting factor(s) but it can identify some approaches to the issue as unsatisfactory.

The situs needs to be known by the payor (who may have to deduct tax

17 See 26.1 (Withholding tax on interest).

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 situs of the source; and

(2) facts not likely to be known by an assignee should not affect the situs.

Many of the connecting factors may change, and it is possible that the source of interest can change its situs. However, it would not be convenient for situs 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 all the main factors:

(1) the payor:
  (a) residence of payor;
  (b) place of business of payor; [18]
(2) payment of the interest:
  (a) place where payment made;
  (b) situs of funds out of which payment is made;[19]
(3) contract under which interest is paid:
  (a) proper law;

18 Place of incorporation is another conceivable connecting factor but no-one has ever suggested it should be relevant.

19 This is often called the "source" of the payment but it is hopelessly confusing to use the word "source" in that way.

   (b) place where contract would be enforced;
   (c) place where contract is made;

(4) situs of debt on which interest is due (i.e. location of deed if debt is a specialty);
(5) place where payor employs capital borrowed (e.g. to purchase UK/non-UK situate asset);
(6) place where money is lent (i.e. place where received);
(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.

(1) Residence of the payor

This is a satisfactory connecting factor. It is true that the payor may change his residence, but this does not happen often, or easily. In the case of dual resident payors, the place of business connected with the loan would usually act as a suitable tie-breaker.[20]

(2) Payment of the interest (place where payment made or situs of funds out of which payment is made)

This is not a suitable connecting factor as it is easily changeable.

(3) Contract under which interest is paid: (a) proper law, (b) place where contract would be enforced, (c) place where contract is made

There are not a suitable connecting factors as they are within the control of the parties.[21]

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20 See 46.11.1 (Dual resident debtor).

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 a difficult concept. Any rules must be somewhat arbitrary. There is almost no case law guidance because the issue is irrelevant for contract law, and only marginally relevant for tax.

(4) Situs of debt: location of deed if debt is a specialty

This is obviously an unsuitable connecting factor. The payor 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 *CIR 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. 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* (1921) 29 CLR 225.[22]

(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.

(6) Place where money lent 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.

(7) Situs of security for debt

A rule that situs of interest on a secured debt depends on the location of the land on which the debt is secured is not sensible or workable, for the following reasons:

22 [1955] NZLR at p.898 accessible on *www.kessler.co.uk*.

(1) A debt may be charged on land 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 a property there worth £100,000? But one cannot have a rule where the situs depends on the relative value of the debt or the security which may fluctuate from time to time.

(3) If land determines the situs, then a debt charged on (say) shares should be situate where the shares are situate.

This rule would allow scope for tax planning.

(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 a payment.

(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.

8.16.2 *Unsatisfactory approaches*

The most unsatisfactory approach of all is to say that it is a question of fact.[23] 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 businessman" would regard as the source. The only way in which a man, practical or otherwise, can identify a source of interest (other than tossing

23 Sometimes a "practical hard" matter of fact but the adjectives are meaningless.

a coin) is to apply a theory as to the priority of the rival connecting factors.[24]

The exhortation to adopt a "practical approach" is harmless but not particularly useful. 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.

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 clear 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.[25] 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 factors have the greatest weight.[26] 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.[27]

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24 Contrast Keynes' dictum that practical men who believe themselves exempt from intellectual influence are the slaves of some defunct economist. The point is made in *CIR v Philips* [1955] NZLR 868 at p.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."

25 *Rhodesia Metals v CT* [1940] AC 774.

26 See 12.3 (Non-resident trader rules).

27 [1955] NZLR 868 at p.896 accessible *www.kessler.co.uk*.

8.17 Case law

The case law makes dismal reading.

8.17.1 *Bank of Greece*

The *Bank of Greece*[28] case concerned a debt with the following features (using the numbering of the list in the above paragraph):

(1) The payor was non-resident.
(2) (a) Payment to residents outside Greece was to be made in sterling.
    (b) Discharge of the payor's obligation would have involved in the ordinary course a payment out of funds situate in Greece.
(4) The debt was secured by lands and public revenues in Greece.
(5) Payment was to be made in London or (at the option of the creditor) in Athens, by cheque on London.
(8) The guarantor was non-resident.

It is obvious (and all sides accepted) that the interest had a Greek source. Almost[29] all the features of the debt pointed the same way, to Greece. The House of Lords held that the interest had a foreign situs 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. However, the dictum is inadequate as a basis for ascertaining situs in other cases. The Court did not say how it reached its conclusion: it just listed all the features of the loan and stated its conclusion.

The conclusion that some have drawn from this case is that all the

28 *Westminster Bank Executor and Trustee Company (Channel Islands) v National Bank of Greece* 46 TC 472.

29 The following features in *Bank of Greece* did not cause it to have a UK source:
- payment made in sterling
- UK proper law
- interest paid into a UK account if the creditor so required.

features listed were relevant, and if different features point in different ways, it is a matter of carrying out a balancing exercise (but how? That is not explained). In my opinion this is a misreading. *Bank of Greece* provides no support for that approach whatsoever. The speech in the case had no need to say anything about the source of interest of the debt because the source was not in dispute. The Court heard no argument about the principles of identifying 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 general test for the situs 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 situs. 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; or (better) to Government securities. It is obvious that interest on Government securities arises in the jurisdiction of the Government concerned.

The actual dispute in *Bank of Greece* concerned the situs of the source of guarantee payments. It is unclear whether such payments are to be classified as "interest" but even if they are not "interest" it is sensible that situs should be determined on principles similar to those which apply to interest. Why was it argued the payment had a UK source?

> [1] The only circumstances relied on by the Appellants as supporting their contention that the obligation was located inside the UK were as follows. Although the original guarantor had no branch in the UK, the present Appellants had acquired one on their universal succession in London.
>
> [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.

These changes did not affect the situs:

> 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.[30]

Bank of Greece is authority for the (sensible) proposition that sources of interest are fixed and not peripatetic.[31] It is nothing more.

8.17.2 *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 payor. 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

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30 46 TC at p. 494.

31 More accurately, the case is authority for the proposition that the changes which occurred in the *Bank of Greece* case did not change the situs. But the changes which occurred there were so fundamental that it is difficult to imagine any other case where the situs will move.

> 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.[32]

Point [1] is right. If a change to a UK guarantor does not affect situs, neither should a change to a UK payor of the interest. This point will not often arise because the facts of *Hafton Properties* (purchase of property subject to mortgage) are extremely 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. It is considered that (whatever the test for situs) the interest does not become UK source merely because the payor comes to the UK.

Point [2] is therefore *obiter*; it is suggested that situs of the debt should not carry much if any weight, for the reasons given above.

8.17.3 *Hong Kong cases and practice*

Thus there is no UK case giving any real guidance. There are some Commonwealth cases.

In *CIR v Hang Seng Bank* [1990] STC 733 at 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 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, 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, 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

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32 59 TC at 426.

Revenue explain:[33]

> 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 *CIR (NZ) v NV Philips Gloeilampenfabrieken,* 10 ATD 435 and *CIR v Lever Brothers & Unilever (1946),* 14 SATC 1.
> 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.[34]

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33 Departmental Interpretation and Practice Notes No. 13 (Revised) Profits Tax: Taxation of Interest Received, accessible *www.ird.gov.hk/eng/pdf/e_dipn13.pdf.*

34 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 situs test for interest. Whether case [1] should be an exception is more doubtful.

8.17.4 *New Zealand and Australian cases*

CIR v Philips' GloeilampenFabrieken[35] is the best of all the cases, because it is the only one which openly addresses and analyses the issues:

> The answer which I should expect the "practical man" to make to a question– What was the source of the money which was received by the Dutch company?– would be the loan it made which means, in effect, the lending of the money– the transaction. The money was paid because the New Zealand company had contracted to pay it; so that, in some sense, it can be said the obligation which had been entered into was the source of the payment made. But one must look behind that. It is seldom that a person makes a payment except under an obligation to do so, and it is, I think, unreal and incompatible with a practical approach to regard the obligation as the source. It is what produced the obligation that is important. A lessee pays rent because he has entered into an obligation to do so, but he has only done this on terms that land is made available to him. An obligation is seldom, if ever, accepted *in vacuo*: it requires some transaction to give it birth. The obligation arises from something which has been, or will be, done to warrant it, e.g., rendering services, making land or other property available. The practical man, in regarding the loan as the source of the payment, would mean, I think, the conduct or the action which was the reason for the obligation being accepted.
>
> ...
>
> To be a "source" of the income within the meaning of the subsection, it is necessary, I think, to look to the originating cause. 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 was drawn from or provided by the trading profits in New Zealand. The New Zealand company 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 Dutch company derived

35 [1955] NZLR 868 accessible *www.kessler.co.uk*.

what it received as income.

8.17.5 *Spotless*

The source of interest was also an issue in *Commissioner of Taxation of the Commonwealth of Australia v Spotless Services*.[36] 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, 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

36 Accessible on *www.austlii.org*. The case went to the High Court of Australia but the source point was discussed only at first instance and on the first appeal.

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.

8.17.6 *Irrelevant case*

I mention the following case only for completeness. In *IRC v Broome* 19 TC 667, the features of the loan were as follows:

(1) (a) The payor 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 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:

> [1] 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. ...
>
> [2] ... 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 in London.

Paragraph [1] is correct: the question was the situs of the source of interest. Paragraph [2] equates the source of the interest with the situs of the *resources* used to pay the interest. That is, with respect, just a confusion caused by the terminology. It is suggested that no guidance should be taken from this case and it has (rightly) been ignored in all the later cases.

8.17.7 *HMRC view(s)*

HMRC formerly took the view that the residence of the payor was the principal (and in most cases the deciding) factor. This position was rejected in *Hafton* and formally abandoned 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—
> – the residence of the debtor,[37] that is the place in which the debt will

37 [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

be enforced;
- the source[38] from which interest is paid;
- where the interest is paid; and
- 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 adopts 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" is 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 cops out:

> It is not possible for [HMRC] to comment individually in advance on 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 ends 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.

IM 3940 contains another HMRC statement:

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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) common law situs principles: see 46.11.1 (Dual resident debtor).

If clarity is ever to enter this area of law, the first necessity is not to use the word "residence" (which has a clear meaning) to mean a concept which has little if anything to do with residence. It is not always true (perhaps not even generally true) that the residence of the debtor is the place the debt will be enforced: see 46.10 (Situs of simple debt). In *Bank of Greece* the debt was enforceable in the UK.

38 [Author's Note] I think this expression means the situs (on common 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 situs on IT principles of the source of income out of which the interest is paid (which could of course be different).

> **3940 Overseas Loans** [October 2003]
> ...
> [1] The proposition that interest paid by a UK resident company or individual to an overseas lender should generally be paid under deduction of tax (unless the overseas lender has claimed exemption under a double taxation agreement) is modified as follows:
> [2] COMPANIES. Where a UK resident company has raised a loan overseas for the purpose of the business of an overseas branch and the overseas branch pays the interest, the interest is regarded as having a foreign source. Conversely, where a non-resident company raises a loan in the UK for the purposes of the business of a UK branch and the UK branch pays the interest, the interest is regarded as having a UK source.
> [3] INDIVIDUALS. Where the debtor is resident in the UK but interest is payable abroad on an overseas loan taken out to buy an overseas asset, or for some other purpose with no UK connection and not secured on UK assets, the interest is regarded as having a foreign source so deduction of tax is not required.

This text has probably survived unrevised from before RI 58. Para [1] assumes that UK residence of the debtor in principle shows the interest has a UK source, a position HMRC abandoned in RI 58. Paras [2] and [3] assume the purpose for which the loan is taken out is a relevant (indeed, determinative) connecting factor, which is not supported by the *Bank of Greece* or any other case. The statement does indicate one "safe haven" situation where one can be confident that the interest paid by a UK resident payer does not have a UK source.

Double Taxation Relief Manual offers yet another approach:

> **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 of assets, not situs of source. The view that situs of assets determines situs of source is contrary to *Bank of Greece* and contrary to principle. The situs of assets rules should play at most a minor role in determining the situs of source of interest. This passage should be dismissed as simply wrong.

8.17.8 *Discussion*

It is submitted that the Courts ought to hold that the source of interest is where the money is lent, i.e. where the money lent is received. This is consistent with case law, principle and international practice, at least in Hong Kong.[39] The 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 RI 58, 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

39 I would be grateful to readers who could direct me to statements of practice from other common law jurisdictions.

debtor. It is suggested that this alone does not give the source of interest a UK situs.[40]

8.17.9 *Commentary*

It is astonishing 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.[41]

A more sensible test would be the test in the OECD Model Treaty.[42] 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 has been "deferred for the time being". This is a reform with winners and losers. The losers in these situations cry louder than the winners, and that may be the reason why the reform has been dropped.

8.18 Income from interest in possession type trusts: identifying the source

8.18.1 *Introduction*

The choice is between:

(1) regarding the trust as the source of trust income; or

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40 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.

41 See 26.5.3 (Double tax treaty defence).

42 Article 11(5) of the OECD Model provides:

> "Interest shall be deemed to arise in a Contracting State when the payer is a 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."

(2) regarding the trust assets as the source, in which case one "looks through" the trust and it is described as "transparent".

The answer depends on the terms of the trust, construed in accordance with the proper law of the trust.

8.18.2 *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.[43] Rather surprisingly, this applies even if the life interest is subject to an annuity: *Nelson v Adamson* 24 TC 36.

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.[44] Then the trust (not the underlying assets) will be the source. In practice this is not normally done.[45]

8.18.3 *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 trust.

This approach requires one to ask whether every trust jurisdiction is:

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43 *Baker v Archer-Shee* 11 TC 749. See "The Nature of a Beneficiary's Interest" 45 CBR 219.

44 *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.

45 Except perhaps unit trusts; see 25.2.3 (Unauthorised unit trust: foreign trustees).

(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.

8.18.4 *Scots trusts*

It is generally accepted that a liferent (i.e. life interest) under a Scots trust in common form is not transparent.[46]

This has been reversed for UK resident Scots trusts; s.464 ITA provides:

> **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

46 "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 approved by Lord Fraser in *Leedale v Lewis* 56 TC at p.538.

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.[47] In practice it will not often matter. One can create a transparent Scots law trust with appropriate wording.[48]

8.18.5 *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 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

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47 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.*

48 "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.

> 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".

8.18.6 *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.

8.19 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.[49]

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49 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

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 page 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.[50]

8.20 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.[51]
> ...
> **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".

> 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.

50 *R v Special Comrs ex p. Shaftesbury Homes & Arethusa Training Ship* 8 TC 367; *Inchyra v Jennings* 42 TC 388.

51 ITTOIA EN explains: Subsection (3) rewrites "or whether the same is received and payable half-yearly or at any shorter or more distant periods".

8.21 Payment from discretionary trust: income or capital?

The position here depends on the terms of the trust power concerned.

8.21.1 *Power over income*

A common form discretionary trust[52] 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.

8.21.2 *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.

A payment under such a power is capital and not income. This is still the case even if:

(1) the payments are made to satisfy an "income purpose", e.g. 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.

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52 For a further discussion of the drafting, see *Drafting Trusts & Will Trusts*, James Kessler, 8th ed., Chap 15 (Discretionary Trusts).

8.21.3 *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". A payment of trust capital under such a power 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 help 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.

8.21.4 *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 paragraph 8.21.2 (Power over capital).

The payment is still capital and not income. In my view 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. In my view 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.[53]

However, in an extreme case, where for tax planning reasons:

(1) income was accumulated;

(2) the accumulated income was distributed (by exercise of a common form power of advancement or appointment) very shortly afterwards; and

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53 Provisions such as ss.660B(2) and 677 ICTA assume this is correct (deeming payments out of accumulated income to be treated as income).

(3) steps (1) and (2) formed part of a pre-arrangement scheme,

HMRC would have an attractive argument that the distribution 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.

8.21.5 *HMRC view*

HMRC accept the views set out above. The TSE Manual provides:

> **3755. Beneficiary receives discretionary payment from a resident trust** [November 2006]
> Trustees of a discretionary trust have the power to decide how to apply the trust income.
> *Trusts and settlements that are not settlor-interested*
> In the case of trusts or settlements that are not settlor-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 IRC* (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.
> ...
> *When payment made*
> For tax purposes the beneficiary received 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.....
>
> **3757 Income of trust beneficiary - discretionary payment from trust capital** [November 2006]
> A discretionary payment made out of trust capital, including a payment out of accumulated income, is usually not regarded as the income of the beneficiary. This view was supported in the case of Stevenson v Wishart and Others (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 IRC* (27 TC 122)

The same point is made in the HMRC Trust & Estate Tax Return Guide:

> Notes to 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.

8.22 Situs of source when source is a trust

Where the trust is the source, how does one decide its situs: 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.

8.23 Income from foreign land

All land outside the UK is treated as a single business, and therefore a single source, no matter how many properties are held: see s.265 ITTOIA. (The wording of the former provision, s.65A(4) ICTA, made the point more clearly; but the current provision is clear enough. See 12.1 (Property income: terminology).) The disposal of one out of a number of properties and the remittance of the rents in the following tax year will not be effective in avoiding a taxable remittance. However, a remittance in the tax year following the disposal of all the properties would be effective.

8.24 Canadian RRSPs, US IRAs, etc

The HMRC view is set out in 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 with`drawals 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.

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.

CHAPTER NINE

THE RFI REMITTANCE BASIS

9.1 The six remittance bases

Income tax and CGT employ two fundamental 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) Relevant foreign income.

(2) Chargeable overseas earnings.

(3) Foreign income taxable under the settlement provisions.

(4) Foreign income taxable under s.720 ITA.

(5) Benefits taxable under s.731 ITA.

(6) Foreign chargeable gains.

In keeping with the patchwork nature of UK tax law, these remittance bases are based on common framework, but have slight differences from each other.[1]

This chapter deals with the remittance basis applying to relevant foreign income. It is here called "the RFI remittance basis" or (where the context is clear) simply "the remittance basis".

9.2 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] But this is what the remittance basis requires to be done. The concomitant of conceptual weakness is unsatisfactory case law and sometimes arbitrary rules with anomalous results. It is not surprising that Viscount Simonds referred to remittances as "this difficult branch of the law".[3]

9.3 History of the remittance basis[4]

The history of the remittance basis is instructive and necessary to understand the older cases. 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, for all except 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 decisions such as those discussed in 8.18 (Income from trusts: identifying the source) which decided whether income filtered through a trust was to be regarded as income arising from securities or income arising from the trust.

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1 It is appropriate that s.761(5) ICTA refers to tax on "*a* remittance basis" rather than *the* remittance basis.

2 *Lipkin Gorman v Karpnale* [1989] 1 WLR 1340 at 1382 (CA). The law of tracing illustrates this in another context.

3 *Thomson v Moyse* 39 TC at 328. Likewise Finlay J in *Kneen v Martin* 19 TC at 140: "This subject is always troubling."

4 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*.

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 and the current position was reached: 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.

9.4 "Relevant foreign income"

Section 830(1) ITTOIA provides the definition:

> In this Act "relevant foreign income" means income which arises from a source outside the UK and is chargeable under any of the provisions specified in subsection (2).

Subsection (2) sets out a comprehensive list, 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. Employment income is governed by ITEPA and discussed in the next chapter. "Relevant foreign income" is not a helpful label but it is difficult to think of a better one.

9.5 Who qualifies for the RFI remittance basis?

Section 831 ITTOIA provides:

> (1) A person may make a claim for a tax year for the person's relevant foreign income to be charged for that year in accordance with section 832.
> (2) The claim must state that condition A or B is met.
> (3) Condition A is that the person is not domiciled in the UK.
> (4) Condition B is that the person is not ordinarily UK resident.

Thus two categories of person qualify for the remittance basis:

(1) the UK resident foreign domiciliary (the subject of this book), and

(2) a person who is:

  (a) not ordinarily resident in the UK; and (by implication);

  (b) resident in the UK (or he would not be within the scope of tax on foreign income at all); and

  (c) domiciled in the UK (or he would fall within the first category anyway).[5]

Category (2) must be a rare case. This category does not qualify for the CGT or employment income remittance bases. 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. For simplicity I will on most occasions ignore this possibility and simply refer to "foreign domicile".

Although the statute does not say so, it is considered that the claim is of no effect if the person is in fact non-resident in the year.

9.5.1 *A "person"*

Under s.831 a "person" who satisfies the relevant conditions can claim the remittance basis. The term "person" generally denotes individuals, trustees and companies. Companies are, however, taken out of the remittance basis by s.12 ICTA.[6]

The remittance basis therefore applies to individuals and trustees. The usual case is, of course, individuals.

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5 A fourth requirement, that the person must be an Irish or Commonwealth citizen, was abolished by ITTOIA.

6 "... 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 9.3 (History of the remittance basis). This is why some of the old remittance basis cases concern companies.

9.6 Remittance basis for trustees

9.6.1 *Position before 2006/07*

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.[7]

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.

9.6.2 *Position from 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.[8] One possible solution is to look to the actual domicile of the

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7 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 320 and the Trusts Consultative Document (1991) para. 10.24.

8 See 5.5 (Trust residence). 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).

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.

9.6.3 *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**
> 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;[9]
>
> 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

9.7 Time of foreign domicile

Condition A in s.831 ITTOIA is that the foreign domiciliary "is" not domiciled in the UK. In the context, it is considered that this means that he is not domiciled at the time the income arises. Domicile at the time the claim is made, or accepted, or at any other time in the tax year, is not relevant.

Section 831 refers to a person who makes a claim "which states that condition A or B is met". Obviously the remittance basis only applies to a person making a claim which states *correctly* that the condition is met. It is an interesting question what is the position if a person changes domicile during a year.

9.8 Rates of tax under arising and remittance bases

See 28.1 (Rates of income tax).

9.9 Claims

A claim must be made every year. It is possible to make a claim in one year and choose not to claim in a later year. HMRC accept this:

> For tax years from 2005/06 onwards individuals who are not domiciled in the UK (or are not ordinarily UK resident) can choose on a year by year basis whether they wish to be assessed on their relevant foreign

9 The Manual adds "is a citizen of the Commonwealth or the Republic of Ireland". However, this condition does not apply from 2005/6.

income ('RFI') on the arising basis or the remittance basis.[10]

How do you make a claim? There is no box to tick (though there ought to be). The Press Release explains:

> A specific claim must be made if the taxpayer wishes to choose the remittance basis, but HMRC have confirmed that the claim will be treated as made if the Non Residence pages and page F2 of the Foreign Pages have been completed. Where no remittances have been made in the year in question, the claim can be indicated by an entry in the Additional Information box.[11]

The Press Release continues:

> That leads onto the question of what action should be taken where a non-domiciled individual has income arising outside of the UK , but has no income arising within the UK and consequently has not received a self assessment return. If they do not file a specific claim under Section 831 ITTOIA 2005 will they be regarded as assessable on the whole of the income arising?

The answer is, obviously yes. The Press Release continues:

> HMRC has confirmed that in these circumstances, the individual will need to consider notifying chargeability under Section 7 TMA 1970. However, if the individual is able to make a claim under Section 831 and there have been no remittances of RFI then there will be no need to notify. If HMRC subsequently enquire into the individual's affairs, there will only be an issue if the individual's personal circumstances do not entitle them to claim the remittance basis or it transpires that there were

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10 Press Release approved by HMRC for issue by professional bodies involved in Working Together (18 May 2007): See [2007] STI 1569. (The same point is made in ITA EN para 1646. This was in fact also the case before 2005/6 but that does not much matter now.)

11 Likewise the HMRC Notes to the foreign pages of the return (called "Notes on Foreign") provides:

> If you claim the remittance basis, enter only the amounts of income received in the UK (include any savings income on Page F2, not Page F1). Apportion any foreign tax paid as appropriate (see Example 1 below). If there were no remittances during the year then make a note in the 'Additional Information' box, box 6.39 on Page F5 to explain that the remittance basis is being claimed.

remittances of RFI that had not been notified.

In practice, in the absence of a return, a claim should be made by letter. The Press Release concludes:

> No deadline is stated for submitting a claim and consequently it appears that the claim can be made at any time up to the fifth anniversary of 31 January following the tax year to which it relates (Section 43(1) TMA 1970).

This is obviously correct.

9.10 Income arising before 2005/06: ITTOIA transitional rules

Paragraph 150 Sch 2 ITTOIA provides:

> A claim may be made under section 831 (claim for relevant foreign income to be charged on the remittance basis) for relevant foreign income to be charged in accordance with section 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 sections 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).

Paragraph 150 is not aptly worded, but what it means is this: if a s.831 claim is made in a year, pre-ITTOIA income (which was not taxed on receipt because a claim was made under s.65 ICTA) is taxed under s.832 if remitted in that year.

9.11 Reasons not to claim RFI remittance basis

A number of reliefs apply to RFI only if taxed on an arising basis:

(1) The 10% deduction on a foreign pension.[12]

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12 See 11.2 (Taxation of foreign pension).

(2) Relief for losses for a foreign trade or foreign property business.

(3) Relief for annual payments made out of RFI, under s.839 ITTOIA.

If no claim is made in any year, relevant foreign income of that year is taxed on an arising basis, but qualifies for these reliefs. The remittance basis still applies for employment income and CGT. See too 9.15 (Remittance without claim for RFI remittance basis).

9.12 The remittance basis: the statute

Section 832(1) ITTOIA provides:

> 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.

9.13 Remittance in tax year after receipt

Section 832(2) ITTOIA provides:

> For the purposes of subsection (1), it does not matter whether the income arises in the year for which the claim is made or arose in an earlier year in which the person was UK resident.

This gives statutory expression to the pragmatic pre-ITTOIA case law.[13]

9.14 Remittance after acquisition of UK domicile

Suppose:

(1) A foreign domiciliary retains foreign income abroad;

(2) acquires a UK domicile; and

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13 *Scottish Provident Institution v Farmer* 6 TC 34; *Patuck v Lloyd* 26 TC 284. (It is interesting to contrast *National Provident Institution v Brown* 8 TC 57, where the House of Lords by a majority applied the principle of the "source doctrine" remorselessly, regardless of the tax planning opportunities thereby revealed.)

(3) subsequently remits the income.

It is clear that there is no charge.

Where a person changes domicile in the course of a tax year, this ought to apply to remittances after the change of domicile, but it might be better to wait until the following year as a precaution.

9.15 Remittance without claim for RFI remittance basis

Suppose a foreign domiciled individual:

(1) makes no claim to RFI remittance basis treatment in any year, and

(2) in that year remits RFI from earlier years in which the remittance basis applied.

There is no tax charge on the remittance. This is perhaps surprising but the position seems clear.

9.16 Income arising when resident, remitted when non-resident

Suppose:

(1) A UK resident foreign domiciled individual receives foreign income which is not remitted.

(2) The individual remits the income to the UK later in a year when non-resident.

If no RFI claim is made in the year of remittance, the income is clearly not taxable. The same is thought to be the case if a claim is made. This is consistent with the CGT position.[14]

9.16.1 *Scope for tax planning in non-resident year*

Suppose an individual has accumulated unremitted foreign income. If he

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14 See 29.7 (Change of residence/domicile).

becomes non-resident for one year, he has the opportunity during that year to remit that income free of tax. If in the subsequent year he becomes UK resident, and remits the income then, there will be a tax charge and the opportunity will have been lost.

9.17 Remittance after death

Suppose:

(1) A UK resident foreign domiciled individual receives foreign income which is not remitted.

(2) The individual dies, and the income is remitted to the UK after the death.

It is considered that no tax charge arises. On the death, the unremitted income becomes vested in the personal representative of the deceased by operation of law. Remittance by them does not count as a taxable remittance: see 27.7 (Receipt by third party). It makes no difference whether the remittance is in the same tax year as the death or later.

9.18 Income arising when non-resident, remitted when resident

Suppose:

(1) A non-resident foreign domiciled individual receives foreign income. The income is not of course taxed as it arises.

(2) The individual becomes UK resident, and subsequently remits that income.

The sum remitted is not chargeable under the RFI remittance basis. This is reasonably clear from s.832(2) ITTOIA. It is also consistent with the CGT position.[15] HMRC agree:

> **Remittance basis: income that can be excluded** Published 9/95

15 See 18.6 (Gains accruing when non-resident, remitted when resident).

> Where the remittance basis applies, it is ordinarily immaterial, subject to the guidance in IM1660–IM1664,[16] in what year the income arose. Where, however ... the taxpayer shows that remittances include income which—
>
> (i) did not arise during a year of assessment in which he was resident in the UK and
>
> (ii) did not arise in the year which is the basis year of assessment,
>
> such income should be excluded from the computation of liability.
>
> *Example*
>
> X, who is assessable for year 3 on the basis of remittances of income in year 2, was not resident in the UK for years 1 and 2. His overseas income is £1,500 each year. He remits income totalling £1,000 in year 2 and shows that £300 of this came from income which arose in year 1. The assessment for year 3, which would normally be on £1,000, may in the circumstances be limited to £700.[17]

9.19 Export and re-remittance

Suppose:

(1) Year 1: A UK resident foreign domiciled individual receives foreign income. Year 2: The income is remitted ("the first remittance") and so subject to tax.

(3) Year 3: The income is transferred out of the UK and remitted again ("the re-remittance").

No-one suggests that there is a second tax charge on the re-remittance. The charge only applies on the first remittance. Section 832 ITTOIA must be read so as to avoid double taxation.

However suppose the same facts except that the income was *not* subject to tax on the first remittance because the individual was not UK resident in year 2, the year of the first remittance. It is suggested that there *is* a tax charge on the re-remittance. In this case there would be no double taxation, and no cause to read the section restrictively.

16 Set out in 6.5 (Year of arrival).

17 Inspectors Manual 1563. The example has not been revised to take into account the abolition of the preceding year basis in 1994, but this does not affect the point being made.

Now suppose:

(1) Year 1: A UK resident foreign domiciled individual receives foreign income.

(2) Year 2: The income is used to satisfy a UK-linked debt and so deemed remitted ("the first remittance") but is not subject to tax because the individual is not UK resident.

(3) Year 3: The money borrowed is transferred out of the UK and then remitted ("the re-remittance").

It is suggested that in this case there is no tax charge on the re-remittance. The receipt of the sum borrowed is not a remittance under ordinary principles, because it is not a receipt "in respect of "the foreign income" (this is why the deemed remittance rules are needed in the first place.) The deemed remittance rules do not apply on the re-remittance because the debt is not satisfied a second time.

9.20 Sums received "in respect of" foreign income

Under the RFI remittance basis, tax is charged on the full amount of the sums received in the UK "in respect of" the relevant foreign income. The remittance of any other sums does not count. This gives statutory expression to the pre-ITTOIA case law.

ITTOIA EN Vol II para 1653 provides:

> The words "in respect of relevant foreign income" have been included, indicating that the sums received should either comprise the relevant foreign income in question, or represent that income. Lord Radcliffe said in *Thomson v Moyse*:[18]
>
> > No doubt proper construction of those words [sums received] require that the sums computable must be "of" the income, by which I would understand "sums of money derived from the application of the income to achieving the necessary transfer."

For the CGT remittance basis the question is likewise whether the amount

18 [Author's Note] 39 TC 291 at p. 335 confirming *Kneen v Martin*.

received in the UK is "in respect of" the chargeable gains. For the employment income remittance basis the statute applies if the earnings "are remitted". It is considered that the test is exactly the same in each case.

9.21 Conditions for the remittance basis charge

Thus three conditions must be satisfied for there to be a charge under the remittance basis:

1. There must be a receipt of relevant foreign income.

2. There must be a sum received in the UK.

3. The sum received in the UK must be in respect of the foreign income.

None of these conditions has proved easy.

9.22 Situs for purpose of remittance basis

There are no statutory rules, so the rules of private international law apply. Thus funds received in a UK branch of a foreign bank are remitted, but funds received in a foreign branch of a UK bank are not remitted.[19] Funds are 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.

9.23 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

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19 See 46.16 (Bank account).

basis is potentially confusing.

A sum received in the UK may not be taxable under the remittance basis because it is not derived 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; or

(3) the source of the income ceased in a previous year.

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 UK resident foreign domiciliary 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.[20] Perhaps it is better described as "income". Best of all is not to use the terminology of capital/income in cases (1) to (4): it is unnecessary to do so.

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20 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."

9.24 Tracing unremitted income

In order to decide whether a sum is received in respect of foreign income, one can (unsurprisingly) trace income through various transformations. If:

(1) unremitted income is used to purchase foreign investments; and

(2) the investments are sold and the proceeds of sale are remitted

there will be a taxable remittance. The proceeds of sale are in respect of the foreign income.[21]

Likewise, if foreign income is invested in assets which are brought to the UK and sold and the proceeds received here; the receipt of the proceeds of sale is in respect of the foreign income.

HMRC agree. Inspectors Manual para 1564 provides:

> The investment of income abroad does not change its character as income and whether the investments or assets are realised abroad and the proceeds remitted here (*Walsh v Randall*, 23 TC 55, and *Patuck v Lloyd*, 26 TC 284) or whether they are transferred here and then realised (*Scottish Provident Institution v Farmer* 6 TC 34), such transactions give rise to 'sums received'.

Likewise the CG Manual:

> **25352. Tracing the gain** [January 2004]
> It has been decided in cases concerning the remittance of income arising abroad that such income does not lose its character on being invested. It can be traced through the investments made in order to decide if and when it has been remitted (See IM1564 and in particular the cases of *Walsh v Randall* (23 TC 55) and *Patuck v Lloyd* (26 TC 284)). You should apply the same principles to capital gains. Therefore, if a gain is not immediately remitted but is instead invested in other assets, in order to decide if a gain has been remitted the gain should be traced through any transactions carried out with the sale proceeds until it is established if a remittance has taken place. Such tracing of gains can be carried

21 This is clear from the current legislation; if authority is needed see *Patuck v Lloyd* 26 TC 284; *Walsh v Randall* 23 TC 55.

through any number of investments, deposits to Bank accounts, transfers between accounts etc.

25353. Tracing the gain

The Manual then refers to the example in CG25351 which is as follows:

(1) *Mr D, who is resident in the UK but is not domiciled here, sells assets located outside the UK for $100,000. This includes a gain computed in sterling of £10,000.*

(2) *Mr D invests the $100,000 sale proceeds in purchasing land in America. Suppose he later sells this land for $120,000 which includes a gain of £5,000 calculated in sterling.*

(3) *If he now transfers the $120,000 to the UK what amount of gain should he be treated as remitting?*

The gain of £10,000 should be traced through the investment of $100,000 in land that was made. When the ultimate sale proceeds of that land of $120,000 are remitted to the UK you should contend that both the gain of £10,000 on the first disposal and a gain of £5,000 on the second disposal have been remitted at that time.

Tracing is not straightforward if assets change their value and the HMRC example above only addresses the easiest case. Suppose T invests £2m foreign income in an asset, and sells it at a loss so he receives only £1m. If T remits the £1m it is suggested there is a charge on £1m only. Conversely if the investment increases in value[22] and T sells it and receives £4m, if he remits half (£2m), it is suggested that only half of the income (£1m) should be regarded as remitted.

Suppose T places unremitted foreign income ("old income") on bank deposit and receives interest ("new income"). The new income is not "in respect of" the old income. The old income is represented by the funds on deposit and the new income is a new asset.[23]

Suppose T invests his old income in a depreciating asset, such as a foreign bond shortly before the interest payment date.[24] After the payment date the individual will receive the interest payment ("the new income")

22 Assume for simplicity no chargeable gain arises for CGT purposes on the disposal.

23 This is supported by the drafting of the definitions of "associated operation" in the TAA provisions and s.268 IHTA. In each case the drafter referred to assets representing other assets, *and* to income arising from such assets. Clearly the drafter considered that the expression "assets representing asset A" did not include income arising from asset A.

24 The same would apply on the purchase of shares in a company about to pay a substantial dividend.

and the value of the bond will fall. It is considered in this case too that the whole of the new income is a separate asset and does not represent the old income (even in part). If this was not the case there could be double or multiple taxation, if the new income is invested repeatedly in bonds and then remitted. Any other rule is impossible to apply because one cannot precisely apportion the interest receipt between income and capital. This conclusion is also consistent with trust law principles: see *Hill v Permanent Trustee Company of New South Wales* [1930] AC 720. However, if this principle was used to extremes, in a tax avoidance context, the Court could be expected to say that the new income does represent the old income "in substance".

9.25 Method of remittance does not matter

In *Thomson v Moyse* 39 TC 291, the taxpayer held foreign income in a US dollar account. He drew a cheque on that account payable to the order of a UK bank. Had he cashed the cheque and received the proceeds in the UK, there would have been a remittance. Instead he sold the cheque to the bank (which cashed the cheque on its own behalf). He argued that he did not *bring in* his dollars to the UK, and so there was no remittance. The House of Lords rejected the argument. There was no requirement to "bring in to the UK" the foreign income (or if there were, the income was "brought in" in the relevant sense).[25]

The position now is even clearer: the question under ITTOIA is whether the sum that the taxpayer received in the UK is "in respect of" the foreign income, and clearly in this case it was.

There is a remittance if there is a "transmission" of income

> from one country to the other by whatever means the agencies of commerce or finance may make available for that purpose.[26]

The Inspectors Manual para 1564 published 9/95 correctly states:

> Income is received in the UK if funds provided in the UK are derived from income arising overseas. The precise mechanisms of banking and

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25 "He parted with his dollars: he got his sterling. He emptied one pocket of dollars in order to fill another pocket with sterling." 39 TC at 333.

26 39 TC at 335.

> commerce used to achieve this result are immaterial. ... Such money does not have to be physically imported. It may be received from another UK resident in respect of the transfer to him abroad of money or assets representing the income.

9.26 UK receipt must be money or commercial equivalent

In *Gresham Life v Bishop*, Lord Lindley said:

> A sum of money may be received in more ways than one, e.g. by the transfer of a coin or a negotiable instrument or other document which represents and produces coin, and is treated as such by business men. Even a settlement in account may be equivalent to a receipt of a sum of money, although no money may pass; and I am not myself prepared to say that what amongst businessmen is equivalent to a receipt of a sum of money is not a receipt within the meaning of the Statute which your Lordships have to interpret.[27]

In *Scottish Widows Fund Life Assurance Society v Farmer* Lord Dunedin, the Lord President, said that the word in the Statute

> is "receipt" and nothing less than actual receipt will do. Now, actual receipt of money, it seems to me, can only be effected in one of two ways. Either the money itself must be brought over in specie, or the money must be sent in the form which, according to the ordinary usages of commerce, is one of the known forms of remittance.[28]

In *Thomson v Moyse*, Lord Denning put the point this way:

> Nor is it necessary that Mr Moyse ... should receive the sums in coins or dollar notes or treasury notes. It is sufficient if he ... receives the sums in England in any of the other forms of money recognized by commercial men, such as bills of exchange, cheques, promissory notes or cash at bank.[29]

Inspectors Manual para 1564 published 9/95 echoes this point:

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27 4 TC 464 at p.476.
28 5 TC 502 at p.508.
29 39 TC 291 at p.340.

> The receipt may be in any commercially recognised form of money, for example, cash, notes, cheques, promissory notes, bills of exchange, or financial credit.

These passages are putting the same point in different ways. They are saying that foreign income represented by financial instruments – such as cheques, promissory notes, bills of exchange, etc. – (which are received in the UK) is regarded as remitted here *if* the instrument is a commercially recognised form of money.

When is an instrument a "commercially recognised form of money"? This question was not discussed in *Thomson v Moyse.* The question is to some extent a question of fact, not law. Commercial practices change over time. Some guidance can be found in contract law cases on "payment" obligations. See *Chitty on Contracts* (29th ed., 2004), Chapter 21, Part 4, especially at 21–055 (Mode of payment).

9.26.1 *Receipt of cheque in UK*

The Inspectors Manual provides:

> **1564.** ... [1] Where ... the receipt is in the form of a cheque, the sum is received in the UK when it is realised in the UK, for example, it is
> [a] credited to a UK bank account (*Parkside Leasing Ltd v Smith* 58 TC 282),

This is self evident.

> [b] exchanged for cash in the UK (through a bank or otherwise),

This is correct: see 9.25 (Method of remittance does not matter).

> [c] accepted by a third party in settlement of a debt owed by the taxpayer ....
> or
> [d] given away as a gift.

Examples [c] and [d] are correct if the proceeds of the cheque are received in the UK.[30]

The Manual continues with a helpful statement:

> [2] 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'.

Point [2] is right since a cheque is not a "commercially recognised form of money". This is obviously so if the cheque is not transferable;[31] the same applies to a cheque which is transferable, unless it is a bankers draft payable to bearer.[32] 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.

9.26.2 *Receipt of marketable bearer bond in UK*

In *Scottish Widows v Farmer* 5 TC 502, foreign income was invested in bearer bonds. The bonds were brought to the UK. It was held that no sum of money had been received in the UK, as the bonds were not the commercial equivalent of money. The bonds were negotiable instruments, and easily marketable, but they were of fluctuating value.

The Lord President said:

> Nobody ever heard of remitting money by means of a bearer bond, for this very good reason: you could not possibly remit money by it and know exactly what you are doing, because the price of bearer bonds fluctuates in the market every day, and a bond might start from New York at one price and arrive in London at a perfectly different one. It therefore is not at all in the same category with that way which modern arrangements have perfected, by which you may send money from one country to another in the form of hard cash consigned in a package or

30 See 9.29 (Receipt by third party at direction of taxpayer) and 9.30 (Transfer of income to third party completed abroad).

31 Cheques drawn on UK banks have generally been non-transferable since the Cheques Act 1992.

32 Another example is *Walsh v Randall* 23 TC 55 which concerned a demand draft in favour of a hospital brought to the UK. It was assumed that there was no remittance until the draft was given to and cashed by the hospital.

> box, or by means of a bank draft, which is, of course, simply a transaction of debtor and creditor between different persons on different sides of the Atlantic. But those are well-known methods of remitting money.

It follows *a fortiori* that the mere investment of unremitted income in assets which are UK situate under common law situs rules does not amount to a taxable remittance. In *Scottish Widows*, the bearer bonds were UK situate under the common law situs rules, but that had "no bearing on the point in question".[33]

9.26.3 *Conclusion*

In summary, cheques, promissory notes, bills of exchange, etc., which represent foreign income and are received in the UK, are taxable remittances only if:

(1) they are "commercially equivalent to money" – which in practice is not usually the case; or

(2) the cheque (etc) is cashed, sold or redeemed, and the cash proceeds are received in the UK.

9.27 Foreign income from bond or coupon held in the UK

Scottish Widows v Farmer 5 TC 502 is a difficult case to follow. A close reading is necessary in order to appreciate that two distinct points were involved. Firstly, foreign income arising abroad was invested in bearer bonds and the bonds were brought to the UK. It was argued that this income had been remitted. The argument was rejected for the reasons set out above.

Quite independently, the taxpayer held foreign bearer bonds in the UK. Coupons were attached to these bonds in the usual way. Before the time came when interest was due on the coupons, the taxpayer company sent each coupon to America, where it was presented. HMRC argued that all the interest from these bonds was to be regarded as received in the UK since the bonds were here, or since the coupons had been here prior to

33 The same point arose on the facts of *SPI v Farmer* 6 TC 34 but the point was not discussed.

their redemption. This argument is obviously wrong. The question is whether the interest on the bonds had been remitted to the UK, thus

(1) the situs of the bonds from which the income arose (under common law situs rules) is obviously irrelevant, and

(2) the situs of the coupons *prior* to the date of payment is equally irrelevant.

The interest could not be remitted to the UK before it was due and payable. This, it is submitted, is what the Court of Session said, or meant to say, in this dictum:

> Now, how can this money be said to have been received in this country? As far as the bond itself is concerned, it is, of course, a piece of paper, but it represents a debt. But the debt is a debt which is not presently payable, but which, taking the bond we have taken as an illustration, is a debt which is not payable till the year 1935, and then is not payable in this country, but in New York. In the same way the interest is not payable here; it only is payable, taking the specimen coupons, on the first day of October, 1907, at the agency in the City of New York. Now, it is quite certain that that debt is still extant until it is paid. That is to say, there is still the debt of the principal till 1936, and if one were speaking of a period before the first of October, 1907, the interest is payable until 1907 comes and it is paid. What I have been absolutely unable to understand is the answer to the question I put, and put in vain so far as any answer was given – how money could be in two places at once. According to the argument of the Crown the money was received in this country the moment the bond came into the Company's safe in London or in Edinburgh. *Equally it was in America, because the day of payment had not yet come, and therefore it was, so to speak, in the pocket of the debtor.* How it can be at one time both in America and in this country is, I think, a difficulty which surpasses even the powers of legal fiction.
>
> (Emphasis added)

It would be more accurate to say that the income did not exist before it became due, rather than to say that it was "in the pocket of the debtor".[34] But nothing turns on this.

9.28 Chattel purchased out of foreign income and brought to the UK

Is there a charge to tax if a taxpayer expends foreign income in the purchase of a chattel (such as a picture or a motor car) and that asset is received by him in the UK or is both received and used in the UK?[35]

The conventional view is that there is no taxable remittance. For a chattel is not "money" (or the commercial equivalent of money) and the line of cases cited above – *Gresham Life v Bishop*; *Scottish Widows v Farmer*[36] – all assume that sums of *money* (or the commercial equivalent)

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34 *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).

35 If bringing the asset into the UK was not a taxable remittance, there would of course be a remittance if the asset is sold and the proceeds received in the UK (unless the source-ceasing principle applied).

36 And a passage in *Thomson v Moyse* where Lord Radcliffe adopted the conventional view:

> "If, having foreign income, I invest it in property, import the property, and then sell it here, the sterling proceeds arise in the UK from a sale made here: yet the proceeds are certainly computable (see, for instance, *Scottish Provident*

must be brought to the UK.

The cases may be distinguished. In *Gresham Life*, foreign income was retained abroad, and the only act HMRC identified as "receipt in the UK" was the credit in the UK accounts. So while no "money" had been brought to the UK, it was also a feature of the case that *the foreign income remained identifiably abroad.* In *Scottish Widows v Farmer*, foreign income was applied in buying bearer bonds which were brought to the UK. Bearer bonds are in some respects equivalent to chattels, and therefore the case supports the proposition that there is no tax charge on the remittance of chattels *in specie*. However, negotiable instruments differ from ordinary chattels and to some extent resemble contracts. See *Chitty on Contracts* (29th ed. 2004), para. 34–002. So there is no case directly covering our point.

The point was debated in the OTPR where Robert Venables QC argued that the importation of a chattel does give rise to a taxable remittance. Richard Bramwell QC took up arms for the conventional view.[37]

> *Institution v Farmer* 6 TC 34)."

The Court was not of course considering our particular question and another passage in the same speech has been cited to support the opposite conclusion:

> "... what importance can there be in the actual place of making the instrument, or in its physical movements, if the direct result of the mechanism employed was to turn the taxpayer's income in one country into money *or value* in the other country, to which he had decided to transfer it?"

37 See OTPR Vol 2, 1992, p.99 (Robert Venables QC); Vol 2, 1992, p.183 (Richard Bramwell QC); Vol 6, 1996, p.23 (Robert Venables QC). I need not repeat the arguments set out in these articles, but will add supplemental points for those who have read the articles and want to take the point further. (1) Dicta in *McCrone v IRC* 44 TC 142 (a case on the Settlement Provisions) support the Venables view: "A 'sum' is just an amount, and payment may be made in various forms, including the transfer of marketable securities of a value equivalent to that sum." (2) There is this practical difficulty with the Venables view. Suppose £100,000 foreign income is spent on a picture. The picture is brought to the UK two years later, worth £50,000. Is there a remittance of £100,000 or £50,000? If the latter, what if it is sold later for £80,000? (3) The statutory definition of 'sum' in s.24(4) ICTA might be taken as supporting the conventional view. This provides "References in this section to a sum shall be construed as including the value of any consideration, and references to a sum paid or payable or to be the payment of a sum shall be construed accordingly." This would not be necessary on the Venables view (except for the avoidance of doubt). (4) Historically, it was envisaged that the charge would only arise on a receipt of money: 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.40 accessible on *www.kessler.co.uk*.

In practice, however, HMRC take the conventional view that there is no taxable remittance. Inspectors Manual paras. 1564 and 1569 provide:

> The investment of income abroad does not change its character as income and whether the investments or assets are realised abroad and the proceeds remitted here ... or whether they are transferred here and then realised ..., such transactions give rise to 'sums received'. *On the other hand, the mere transfer to the UK of such investments or assets* other than commercially recognisable forms of money does not constitute 'sums received' (*Scottish Widows' Fund Life Assurance Society v Farmer* 5 TC 502).
>
> ...
>
> If an overseas credit card is used abroad and the account is settled direct to the card company out of overseas income within Cases IV and V, no liability to UK tax will arise. But if an asset purchased using the card is brought to the UK *and subsequently sold here*, there will be a taxable remittance, *at the date of disposal,* up to the amount of any Case IV or V income used to settle the original account.
>
> (Emphasis added)

9.28.1 *Dividend of chattel in specie*

Sometimes a person receives income which is not in the form of money. The common example is where a company declared a dividend *in specie* of a non-cash asset.[38] Suppose a foreign domiciled shareholder receives a dividend in specie of UK situate property such as land or a chattel. It is considered that there is no taxable remittance unless the chattel or other asset is sold and the proceeds received in the UK. This is so even if the land is occupied or the chattel is used and enjoyed by the shareholder. The same applies if the dividend *in specie* is to a discretionary trust, and the trustees distribute the non-cash asset *in specie* to a beneficiary.

9.28.2 *Application of trust income for benefit of beneficiary*

Where trust income is applied for the benefit of a beneficiary, for example by maintaining him, then the income so applied becomes that of the

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38 A company usually has power to do this: see Table A article 105.

beneficiary for tax purposes.[39] It is considered that there is a charge under the remittance basis only if the income is actually received here before being so applied (as was the case in *Drummond v Collins* where the income was paid to the mother of the beneficiary, to apply for his benefit).

9.29 Receipt by third party at direction of taxpayer

The case law is a little difficult. In *Timpson's Executors v Yerbury*[40] 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. There are two possible bases for the decision: the reason given by Lord Wright MR differs from that given by others.

All the judges referred to the rule ("the liability rule") that the person liable for tax on income is the person receiving *or entitled* to the income.[41] The conclusion that Lord Wright MR drew from this rule, and the basis on which he decided the case, was 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.[42]

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. Lord Wright assumed that T's money went on a journey, starting in New York, passing through the doors of the UK bank and ending in the children's bank account. This would have been correct if money in the form of coins or notes had been sent from America, or a bankers draft

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39 *Drummond v Collins* 6 TC 526; *Stevenson v Wishart* 59 TC 740 at p.757.

40 20 TC 155 followed at first instance in *Walsh v Randall* 23 TC 55.

41 The rule is now in many places in ITTOIA: see in particular ss.371, 385, 404 ITTOIA.

42 20 TC at p 180; likewise *Carter v Sharon* 20 TC 229 at p 240: the charge applies to income "which is either received by the taxpayer in this country or to which he is entitled at the time it comes to this country."

which is the commercial equivalent of money.[43] But the cheque was not money, and the credit transfer from T's account and the children's account did not strictly involve any moment when T was entitled to money situated in to the UK.[44]

However, Romer LJ and (I think) Greene LJ decided *Timpson's Executors* on a slightly different, wider basis: there is a remittance charge if:

(1) money is received in the UK at T's direction, and

(2) immediately before receipt the money (or funds representing it) belonged to T.

They do not ask whether T was entitled to the money on arrival, at the time it came to the UK.[45] 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* ...

43 See 9.26 (Receipt must be of money or commercial equivalent).

44 The argument was first raised by a judge in the Court of Appeal, and the law easily takes a wrong turn in such a case. But possibly this analysis of money transfers, which is now accepted (see *Law of Bank Payments*, Brindle and Cox, 3rd ed. 2004 para. 3-762 and *R v Preddy* [1996] AC 815) was not clear law when *Timpson's Executors* was decided.

45 "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).

This is better, because the remittance basis does not actually require money to be "brought in" to the UK, so the question of who is entitled at the time the money comes to this country is not a meaningful question to ask. It is not even necessary to rely on the liability rule to justify this reasoning. It would be sufficiently supported by the terms of the remittance basis itself: "tax is charged on sums received in the UK in respect of the income." When there is a receipt at the direction of T, sums are received in respect of the income.

So if a foreign domiciliary writes a cheque on a foreign bank account, gives it to a donee, who cashes the cheque in the UK, there is a remittance of the foreign income.

Suppose income is transferred from an offshore account direct to a third party's UK account by electronic transfer (not by cheque). On the view adopted in this book, there is a taxable remittance. There is no difference between sending a cheque and a direct electronic transfer. It would be strange if there were.

It makes no difference if the payment is a gift or in satisfaction of a debt due for goods or services.

9.30 Transfer of income to third party completed abroad[46]

9.30.1 *Gift of foreign income*

If a foreign domiciliary ("A") transfers his foreign income to another person ("B") and B receives that income abroad, there will be no taxable remittance of that income even if B subsequently remits the income to the UK. See *Carter v Sharon* 20 TC 229. 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.

If a foreign domiciliary wishes to make gifts to UK residents he can therefore do so out of his foreign income without incurring any tax. It is only necessary to arrange for the income to be received by the donee abroad. The donee can subsequently bring the income into the UK. In this way a foreign domiciliary can effectively remit income to his children or even to his spouse, though not to himself.

The gift must be completed outside the UK. The easiest procedure in

46 See also 9.37 (Circular transaction returning income to taxpayer).

practice is to arrange that the income is credited to a foreign bank account in the name of the donee. An alternative is to deliver cash or a bankers draft to the donee abroad. If a cheque is sent from abroad to the donee in the UK, and cashed here, the payment is received here as the cheque is revocable until cashed. However, if an irrevocable bankers draft is posted from abroad, the gift is normally completed when the cheque is posted, so the gift is completed abroad.[47]

Inspectors Manual 1565, published 9/95 provides:

> It may be claimed that income arising abroad has been alienated from the taxpayer's possession by gift abroad (for example, to a relative) so that it is no longer his income when received in the UK. This may be challenged on the grounds that
> [1] the gift was not completed until the income was received in the UK (*Timpson's Executors v Yerbury* 20 TC 155) or
> [2] that financial consideration for the 'gift' has been received in the UK.
> Before any such claim is accepted, a full report should be made to Revenue Policy, International (Cases IV and V), Victory House.

Point [2] is correct if "financial consideration" for the gift means consideration in the form of money.

9.30.2 *Purchase of foreign situate asset out of foreign income*

Suppose an individual purchases a foreign asset with foreign income for full value. If the purchase price is paid out of the UK, there is no remittance.

Suppose the purchase price is paid by a remittance to a UK account of the vendor. It might be thought that there is a remittance under the principle of *Timpson's Executors*: the receipt in the UK account is "by the authority" of the individual.[48] It is considered that there is no remittance: under the tracing principle, the foreign income becomes identified with the

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47 *Carter v Sharon* 20 TC 229 at 240. This assumes that one applies the English law rule that receipt by the post office is receipt by the addressee, i.e. the post office is agent of the addressee. It would be different if a foreign post office adopted a different rule (though a Court would assume the English law rule applied in the absence of evidence to the contrary).

48 See 9.29 (Receipt by third party).

foreign asset – which remains outside the UK. (If large sums are involved, it would be wise to make the payment outside the UK, for the avoidance of doubt.)

9.30.3 *Purchase of UK situate asset out of foreign income*

Suppose now the individual purchases a UK situate chattel. Suppose that the purchase price is paid abroad (e.g. to a foreign bank account of the vendor). Is this a remittance?

It is considered that there is no remittance. For no sum of money is received in the UK. The issue is similar to that discussed above in relation to chattels. It would be anomalous if:

(1) importation of a chattel was not a taxable remittance;

(2) purchase completed abroad of a UK situate chattel was a remittance.

If that is right, there is no taxable remittance on the purchase of UK situate land, if the purchase price is paid abroad.

The taxpayer would be in a stronger position if a company or trust, funded out of foreign income, uses its funds to purchase the land.

9.30.4 *Payment for services out of foreign income*

Similar considerations apply to payment for services rendered in the UK. If RFI is used to make the payment outside the UK, it is considered that there is no taxable remittance: no "sums" are received here. It is understood that some firms of solicitors and accountants maintain offshore bank accounts in order to facilitate payment by foreign domiciled clients. The argument is similar to that on the purchase of an asset in the UK, but may be stronger, as it may (depending on the services) be harder to identify "value" in the UK.

9.30.5 *Repayment of debt of another out of foreign income*

Suppose A borrows money in the UK and another individual (B) satisfies the debt by a payment out of foreign income. There is no remittance by B if the payment is completed abroad.

9.30.6 *Repayment of own debt out of foreign income*

Suppose T incurs a debt in the UK, and satisfies it by a payment completed abroad. If the debt is incurred "for money lent" (or is interest) the deemed remittance rules need to be considered. Otherwise, the payment is not a remittance. This may seem a technical and unmeritorious point. But when the boot is on the other foot, HMRC are likewise entitled to take, and do take, the technical and unmeritorious point that release of a debt is not the payment of a sum of money.[49]

9.30.7 *Loan to another made from foreign income*

Suppose:

(1) an individual lends foreign income to a borrower. The loan is completed by a payment out of the UK.

(2) the borrower remits the sum he borrowed to the UK.

There is no remittance of the foreign income, for two reasons:

(1) The foreign income has ceased to be the income of the individual, and the principle in *Carter v Sharon* applies;

(2) The foreign income is represented by the loan, under the tracing principle. If the loan were called in (or sold) and the proceeds remitted, there would be a remittance.

This is so even if the loan is on favourable terms, or interest-free.

9.31 Debit, credit and charge cards

This section considers whether the use of debit, credit and charge cards involves a remittance for the purposes of the remittance basis. The current HMRC investigation into offshore bank accounts makes this issue topical.

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49 See *Taxation of Charities*, James Kessler QC, Key Haven Publications, 5th ed., para.14.8.

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*.[50]

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 only issued by a bank. The contract between the card-issuer bank and cardholder authorises the bank to debit the cardholder's account with the amount of the card transaction.

(b) Charge and credit cards are different. Here the cardholder is required to make a payment to the card-issuer. A *charge* card requires the cardholder to repay the balance outstanding after a set period.[51] 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. It is also necessary to consider separately whether

50 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.

51 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).

there is a remittance under (1) ordinary remittance basis principles and (2) the deemed remittance rules.[52] The Inspectors Manual distinguishes between "UK Cards" and "Overseas Cards" and it distinguishes between cards "used in the UK" and "used abroad". I consider the meaning of these expressions below.

9.31.1 *Cards used to obtain cash*

If a debit card is used to obtain cash in the UK from a foreign account which is in credit,[53] and the card is used at a branch of the bank which issued the card, then there is clearly a remittance of the money on ordinary remittance basis principles. 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.

It is considered that the use of a *charge* card to obtain cash in the UK from a foreign account is a remittance by one of the "agencies of commerce" and so is a remittance under ordinary principles.[54] The time of the remittance is when the sum is debited from the account, not when the card is used.

What is the position if an individual uses a *credit* card to obtain cash in the UK? There is a remittance under ordinary remittance basis principles if the use is "merely a means of transmitting income". By contrast, if the card is used not to transmit income but as a method of borrowing, then there is no remittance under ordinary principles, neither when the money is borrowed nor when the borrowing is repaid.

One might therefore contrast two different ways that a credit card can be used:

(1) If the card is used to obtain credit, e.g. if the balance on the card is not repaid at the earliest opportunity, then there is clearly no remittance under ordinary principles.

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52 See 9.39 (Deemed remittances).

53 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 deemed remittance rule will in principle apply when the overdrawn account is repaid.

54 See 9.25 (Method of remittance does not matter).

(2) If the balance is repaid at the earliest opportunity, the position seems less clear. Two views seem possible:

   (a) It may be said there is a debt, even though a short-term one, and the position is as (1) above.

   (b) HMRC might argue that in economic substance the charge card is simply a form of "plastic money". The position is the same as a debit or charge card.

A modern Court may not view with favour a formal distinction between credit and charge card. However the tax planning possibilities which result are limited by the deemed remittance rules, and the decision to restrict the deemed remittance rules to persons who are ordinarily resident suggests that tax planning of this kind by non-ordinarily resident individuals is acceptable. Moreover, any distinction other than the formal distinction between debt and methods of transmitting money is difficult to apply in practice. So it is considered that there is no remittance on ordinary principles when a *credit* card is used to obtain cash, even if payment is made to the card-issuer at the earliest opportunity.

I turn to consider the deemed remittance rules. These rules only apply to an individual who is ordinarily resident in the UK.

In the case of a debit card, there is no debt for money lent so the deemed remittance rules do not apply. Since use of a debit card involves a remittance on ordinary principles this does not matter.

Where a credit card is used to obtain cash there is a "debt for money lent". Assuming the money is lent in the UK, or received in the UK, this is a UK-linked debt, and a subsequent payment from a foreign account to satisfy the debt is *prima facie* a deemed remittance under the deemed remittance rules. If the cash is withdrawn in the UK, then the sum is lent in the UK and both the debt and interest are within the deemed remittance rules.

Where a charge card is used to obtain cash, there is also a debt for money lent. What about the overlap with the ordinary remittance rules which arises when a charge card is used? Since the sum used to repay the debt is actually received here, it cannot be *treated* as remitted here: one cannot deem to be the case that which is actually the case. But the deemed remittance rules can apply on repayment of the interest on a charge card.

9.31.2 *Cards used to obtain goods or services*

Where a debit card is used to obtain goods or services, money passes from the cardholder's account to the supplier's account. If the supplier's account is in the UK, it is considered that there is a remittance of the money transferred to the UK, under ordinary principles, because the money is received in the UK by authority of the cardholder.[55] Whether the card is a UK card or an overseas card is irrelevant.

What is the position where a UK credit or charge card is used to obtain goods or services? HMRC focus on the payment which comes from the individual's foreign account to the card-issuer's account. The Inspectors Manual provides:

> **1569. Remittance Basis: Use of credit cards** Published: 9/95
> If a taxpayer who is chargeable on the remittance basis uses a UK credit or charge card to pay for goods or services, either in the UK or elsewhere, and subsequently settles his credit[56] card account out of overseas income chargeable under Case IV or V of Schedule D, then the payment sent to the UK to settle the [credit card] account constitutes a taxable remittance, even if it is made direct to the credit card company, since the remittance does not have to be received by the taxpayer personally, it merely being sufficient that it is received in the UK by some other person on his authority (see IM 1564(1)).

This is correct. For this purpose, I think, by "UK card" the Manual means a card whose issuer has a UK bank account, into which the cardholder makes payments. For such cards there is a remittance under ordinary principles. The time of the remittance is when funds are paid to the card-issuer's account, not when the card is used.

The line of argument used against UK cards does not apply to a card where the card issuer has a foreign bank account into which the cardholder makes payment. This is what the Manual refers to as an "overseas credit card".

The Manual continues:

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55 See 9.29 (Receipt by third party).

56 The Manual refers once to "a credit or charge card" and thereafter to "a credit card". I assume that the Manual regards credit cards, charge cards and debit cards as all identical for tax purposes.

> Where an overseas credit card is used in the UK instead of cash, the taxpayer is effectively authorising the credit card company to settle his account [with the supplier] in just the same way as if the taxpayer had instructed his foreign banker to send a remittance to the supplier. If, on that basis, the taxpayer's overseas income is ultimately the provider of sums received in the UK (by the supplier) then there is a taxable remittance.

For this purpose, I think, a card is "used in the UK" if the supplier's bank account (which receives the money) is in the UK.[57] If it is, HMRC here adopt a "economic substance" approach and regard the card as a method of transmitting money from the individual's foreign account to the supplier's account in the UK. Hence there is a remittance under ordinary principles. It is considered that this is correct for a charge card but not for a credit card (which is a method of obtaining credit, not of transmitting money; see above).

HMRC then turn to consider a fallback argument based on the deemed remittance rules:

> It is sometimes argued that any indebtedness created by the use of an overseas credit card lies between the cardholder and the card company, rather than between the cardholder and the supplier.

This "argument" is in fact absolutely correct. When a card is used, there is no indebtedness between cardholder and supplier and there is an indebtedness (i.e. a debt) between cardholder and card issuer. In these circumstances, HMRC contend that the deemed remittance rules apply:

> The debtor/creditor relationship thus established, however, amounts to a loan of money expended on purchase by the debtor by the use of his card, which would be caught by ICTA s.65(6).

This is very doubtful. There is certainly a debt owed by the cardholder to the card-issuing company. But is it a debt "for money lent"? Strictly the only possible answer is, no. There is no loan. But the debt is the commercial equivalent of a loan; would a modern Court apply a purposive

57 It is irrelevant where the cardholder is physically present in the UK at the time of the credit card transaction.

construction? One difficulty in doing so is that the Court would then have to decide whether the money is lent in the UK or out of the UK. Since no money is actually lent, the question is unanswerable. The Inspectors Manual raises this question but does not answer it:

> The terms of the particular credit card agreement must be examined. If, under the terms of the agreement, the money is regarded as lent to the cardholder at the moment when his card is accepted as payment in lieu of cash, then the lending can be said to take place in the UK and any repayment of either the loan or any interest out of Case IV or V income is regarded as a taxable remittance.
>
> If, on the other hand, the money is only regarded as being lent at the date the overseas card company settles the supplier's account on the cardholder's behalf, then the lending takes place outside the UK and ICTA, section 65(6)(b) operates to treat the repayment of the loan, but not any interest, as a taxable remittance.

If any Inspector actually followed this instruction and examined the terms of the credit card agreement, he would, I expect, be disappointed. The agreement will not address the issue of where the money is lent, because as far as the cardholder/issuing company is concerned, this is not a question which arises or ever could arise. For this reason it is suggested that the deemed remittance rules will not apply when an overseas credit card is used to acquire goods or services.

The Inspectors Manual continues:

> If an overseas credit card is used abroad and the account is settled direct to the card company out of overseas income within Cases IV and V, no liability to UK tax will arise.

This is correct; note for this purpose, I think, a card is "used abroad" if the supplier's bank account which receives the money is outside the UK.

The Inspectors Manual concludes:

> But if an asset purchased using the card is brought to the UK and subsequently sold here, there will be a taxable remittance, at the date of disposal, up to the amount of any Case IV or V income used to settle the original account.

It is considered that this is correct in the case of a debit or charge card but not for a credit card.

9.31.3 *Credit cards: conclusion*

In summary, the position is as follows:

(1) If a debit card is used to obtain cash in the UK from an account in credit, there is a remittance of the money received in the UK on general principles.

(2) If a charge card is used to obtain cash in the UK from an account in credit, it is considered that there is a remittance of money received in the UK on general principles.

(3) If a credit card is used to obtain cash in the UK, it is considered that there is no remittance either on ordinary principles or under the deemed remittance rules, though HMRC do not agree.

(4) If a debit card is used to obtain goods or services, and the supplier receives the payment in an account in the UK, there is a remittance on ordinary principles.

(5) If a UK credit or charge card is used to obtain goods or services, there is a remittance on ordinary principles.

(6) If an overseas charge card is used in the UK, it is considered that there is a remittance on ordinary principles.

(7) If an overseas credit card is used in the UK, it is considered that there is no remittance on ordinary principles, though HMRC do not agree.

(8) If an overseas card is used abroad, there is in principle no remittance.

Clients should be advised to use overseas credit cards for transactions abroad.

Clients should be advised not to use overseas credit cards in the UK, because this is likely to lead to a dispute with HMRC, but if this course has been taken, any assessment should be resisted.

9.32 Mixed funds: introduction

It can happen that there are brought together into a single fund two (or more) funds which are of a different nature and which qualify for different tax treatment under the remittance bases. The classic example is a mixture of:

(1) unremitted foreign income (taxed on the RFI remittance basis) and

(2) capital (e.g. an inheritance) not taxed at all on remittance.

However, the variety of possible ingredients of a mixed fund is much greater than this. One might have:

(1) Foreign investment income (taxable on remittance under RFI rules).

(2) Chargeable overseas earnings (taxable on remittance under employment income rules).

(3) Income on which some foreign tax has been paid (taxable on remittance but with credit under DTT rules). Income from different sources may have different amounts of credit available.

(4) "Income" which is not taxable on remittance because:

    (a) the sum has already been subject to income tax; or

    (b) the donor was non-resident when this particular sum arose; or

    (c) the source of the particular investment income has ceased.

(5) Proceeds of disposals on which a chargeable gain has accrued (taxable on remittance to the extent of the gain). Almost every disposal will be a different mix of base cost and capital gain.

(6) "Capital" (not being sums representing income or chargeable gain) tax free on remittance.

Any combination of these funds may become mixed. This section discusses the problems which then arise when some (but not all) of the money is remitted to the UK. Does the money remitted represent one fund or another or a mixture of both?

9.33 Income and capital accounts at one bank

In *Kneen v Martin* 19 TC 33 the taxpayer paid foreign income into one foreign account (described as an "income account"). He paid the proceeds of sale of the shares from which the income was derived into another account at the same bank (described as a "capital account"). He later remitted a sum from the capital account and that was held to be a remittance of the capital. It must follow that:

(1) different types of funds are not "mixed" if they are held in separate accounts at one bank, or

(2) they are "mixed" at the bank but "unmixed" by a remittance from a specified account so what is remitted can be identified as either income or capital.

Since a bank (as a matter of banking law)[58] owes only a single debt to its customer, even if the customer has two accounts, analysis (2) is to be preferred.

9.34 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");[59] and

(2) foreign income which qualified for the remittance basis, and which was therefore untaxed unless and until remitted ("untaxed income").

58 This assumes that English banking law principles apply; that is to be assumed in the absence of evidence of foreign law.

59 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.

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. 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.[60]

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[61] 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:

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60 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).

61 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."

> **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 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.

9.35 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 9.34 (Taxed and untaxed income);

(2) capital and capital; see 9.36.1 (CGT remittance out of mixed capital funds).

In some cases it may be difficult to identify sums as "income" or "capital": see 9.23 (Capital/income terminology in remittance basis context).

9.35.1 *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.

9.35.2 *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*[62] 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: see 9.20 (Sums

62 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.

received "in respect of" foreign income). Likewise the extensive trust law cases on tracing are of no assistance here – that tracing approach was expressly rejected in *Roxburghe*.

9.36 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.

Then this issue does not arise and a remittance from the DTT account can easily be identified as qualifying for DTT relief.

9.36.1 *CGT 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.

For the quite different question where a disposal has given rise to a gain, and it is desired to separate the original capital "tranche" and the gain, see 29.5 (Remittance of gain or base cost).

9.37 Circular transaction returning income to taxpayer

In *Harmel v Wright* 49 TC 149, a taxpayer used his foreign employment income to subscribe for shares in A Ltd; A Ltd lent the money to B Ltd; and B Ltd lent the money back to the taxpayer. Applying the principle in *Carter v Sharon*, there should have been no remittance, since the income had been transferred to a third party out of the UK: see 9.30 (Transfer of income to third party completed abroad).[63] But the taxpayer had the misfortune to appear before the vehement opponent of tax avoidance. The result was inevitable. Templeman J said:

> Although at various stages different cheques are written on different accounts, one can, with fascination, with certainty and no difficulty at all, follow, for example, a salary of £25,000 paid by cheque from the South African company [the employer] to the taxpayer; then by cheque by the taxpayer to Artemis; then by cheque by Artemis to Lodestar, and finally by cheque by Lodestar to the taxpayer in England. Ignoring for the moment exchange control and the possibility that some cheques will be in rands and others in sterling, and ignoring the costs that will drip away, that sum begins in South Africa from the employers of the taxpayer and ends up in this country with the taxpayer. In my judgment, in the peculiar circumstances of this case – and I say nothing about other cases where it may be possible that the money *does en route disappear and it is not possible to follow with the same certainty as in the present case* – the sums which the taxpayer eventually receives represent and are the emoluments which start off from his South African employers in the first place.
> [Counsel] for the taxpayer says ... the emoluments are not received in this country because they have become, and are, the shares in Artemis,

63 An independent argument arises under the tracing principle: the assets held by A Ltd could not represent the taxpayer's income, since income was represented by the shares in company A. There would have been a remittance if the shares were sold and the proceeds of sale remitted.

and what the taxpayer receives in this country is something entirely different, namely, a loan extended to him by Lodestar. He submits that it is impossible to come to any other conclusion unless one strips aside the corporate veil and looks behind Artemis to study the shareholders and looks at the reality of the situation behind the corporate veil.

[1] To my mind this case does not depend on stripping aside the corporate veil at all.

[2] This case depends on keeping one's eye on the emoluments, on the original sum of £25,000, and seeing what happens to it. It is true that it is paid over at one stage as the purchase price for shares, and it is true that one cannot normally identify money, but in the present case you can; you do not need to get behind the corporate veil to perceive and know that the £25,000 which goes in as the purchase price for shares comes out on the instant in the form of the loan to Lodestar. In my judgment, on the wording of section 156[64] one does not need to strip aside the corporate veil if you find that emoluments, which mean money, *come in at one end of a conduit pipe and pass through certain traceable pipes until they come out at the other end to the taxpayer.*[65]

(Emphasis and paragraphing added)

This judgment does little to help in other cases as:

(1) Sometimes money "comes in at one end of a conduit pipe and passes through certain traceable pipes until it comes out at the other end to the taxpayer"; I call this "the *Harmel v Wright* principle".

(2) Sometimes money "does en route disappear and it is not possible to follow with the same certainty" and the *Harmel v Wright* principle does not apply.

The judge says "nothing" about where the dividing line comes. This is one of those omissions which so commonly make Templeman judgments easy to read but difficult to apply.

In *Grimm v Newman* [2002] STC 1388 the taxpayer had foreign

64 Section 156 Income Tax Act 1952 imposed a charge on emoluments "received in the UK".

65 49 TC at p.157.

employment income (chargeable overseas earnings) which he gave to his wife. The transfer was completed abroad. He and his wife purchased a house jointly, his wife using the sum she had been given to pay for her share. They lived in the property together. The *Harmel v Wright* principle did not apply. Paras 57–60 of the judgment read:

> [1] ... Mr Grimm [did not retain] any beneficial interest therein or contractual right of control over the property he gave to Mrs Grimm. Thus ... the investments were the absolute property of Mrs Grimm for her to do with them what she willed. On the basis of *Carter v Sharon*, at that stage the investments lost the characteristics which made them potentially liable to UK tax in the hands of Mr Grimm.
>
> [2] Second, the passages in the speech of Lord Radcliffe in *Thomson v Moyse* to which I have drawn attention do point to the need for monetary or financial equivalence between the foreign income or emolument and that which is received, used or enjoyed in the UK. Mr Grimm did not receive, use or enjoy the monetary or financial equivalent of what he gave. ...
>
> [3] Third, the analogy with *Harmel v Wright* is false. In that case the taxpayer received from Lodestar the monetary equivalent of what he had disposed of to Artemis. The original disposer and ultimate recipient was the same and the "conduit pipe" through which the money was poured readily identifiable.

As I see it, paragraph [1] represents the *prima facie* position, the rule in *Carter v Sharon*. Paragraphs [2] and [3] represent the reasons for rejecting the challenge to it:[66]

[2] The taxpayer did not receive use or enjoy the monetary equivalent of

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66 The following paragraph of the judgment raises two side issues. Firstly:

> "... the real issue, as it seems to me, is whether the legislation dealing with constructive remittances entitles the court to treat husband and wife as the same person. In my view it does not. In many contexts specific provision is made to that effect. But in the context of constructive remittances there is no such provision in the legislation and, in my view, none can be implied."

This conclusion is obviously correct. Secondly:

> "Likewise, there is nothing in the *Ramsay* principles ...to justify any such treatment."

Interesting that the judge refers to the *Ramsay* principles (in the plural). But that is another book.

the foreign income which he gave to his wife.

[3] The *Harmel v Wright* principle only applies when the money received by the taxpayer is "readily identifiable" with his foreign income. That was, apparently, not the case in *Grimm v Newman*.

One explanation of *Harmel v Wright* is that it represents a pre-*Ramsay* application of the *Ramsay* principle. (It would help if the Courts would make up their mind what the *Ramsay* principle is.) However, this is not the way that the *Harmel v Wright* principle has been expressed, either in *Harmel v Wright* itself or in *Grimm v Newman*. I suggest that the dividing line between *Carter v Sharon* and *Harmel v Wright* ought to be, and is likely to be, formed upon the following lines.

9.37.1 *Transfer via trust which benefits individual*

Suppose:

(1) T transfers unremitted foreign income to a trust under which he is the principal beneficiary; and

(2) the trustees transfer or lend the funds to him in the UK.

Even if the two steps are not part of a preordained series of transactions, and the trustees have genuinely exercised their discretion, this falls within *Harmel v Wright*: T has received the monetary or financial equivalent of what he gave. The funds are readily identifiable. The transfer to the trust does not amount to 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.

Suppose T transfers £1m unremitted foreign income to a trust, the trust invests and realises a gain on the disposal being left with £3m. If the trust transfers £1m to T, it is suggested that one third of the original income should be regarded as remitted. On the other hand, if T *lent* £1m to the trust, the trust invested and realised a gain leaving £3m, the trust repaid the loan (offshore) and then transferred £1m to T, who received it in the UK, that would be tax free. It is considered that the position is the same even if the loan is not repaid, as long as the trustees retain sufficient assets to repay it.

Suppose an individual T transfers unremitted foreign income to a trust under which he is the principal beneficiary, and

(a) the trustees transfer the funds to the UK (but not to T);

(b) the trustees use the funds to purchase assets from T; or

(c) the trustees use the funds to purchase from a third party a UK property which T occupies.

It is considered that there is no remittance in any case. Case (a) is clear as T does not receive the funds. Case (b) is not a remittance since T has given value for the sum he receives. In case (c) what T receives is merely the licence to occupy the property, and does not amount to the financial equivalent of the foreign income.

9.37.2 *Transfer via another individual*

Suppose:

(1) T transfers unremitted foreign income to an individual, W; and

(2) W transfers or lends the funds to T.

In this case it is suggested that the line should be drawn depending on whether or not the decision by W to transfer assets to T is genuinely independent. The question is very similar as to whether a person has provided funds indirectly and so is a settlor.[67] It is submitted that the same test should be applied.

This 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.

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67 See 45.32 (Tax planning to create settlement with foreign domiciled settlor).

(3) The son lent the money to a company.

The Special Commissioner said:

> I cannot overlook the fact that once the money had been borrowed [by][68] 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.*

Suppose W uses the income given to her to meet living expenses in the UK which would otherwise be joint expenses of T and W. It is considered that there is no taxable remittance – all that matters is that the funds do not return to T himself.

9.38 Foreign exchange profits and losses

The Inspectors Manual provides:

> **1670. Exchange**
> Income chargeable on the arising basis should be translated into sterling at the rate of exchange prevailing at the time when the income arose (see IM1640); where, however, credits are frequent and the taxpayer desires to translate at the mean rate of exchange for the basis year, that course may be followed, provided that it is adopted consistently year by year, and that the amounts to be assessed are not materially affected. ...

This is not contentious. The HMRC website offers an exchange rate calculator.[69] The Manual continues:

> ... Where income is chargeable on the remittance basis, the income should be taken to be the amount received in the UK, translated to sterling, if necessary, at the rate of exchange prevailing on the date of

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68 The text erroneously reads “from”.

69 *www.hmrc.gov.uk/exrate/index.htm*.

> receipt.
> Any case of difficulty should be referred to Business Tax (Technical).

This is more doubtful, as the last sentence tacitly accepts. There is no authority on the point.

9.39 Foreign income used to pay debt: deemed remittances

Sections 833, 834 ITTOIA prevent avoidance schemes of the kind which succeeded in *Hall v Marians* 19 TC 582 and *IRC v Gordon* 33 TC 220. I refer to these provisions as "the deemed remittance rules". They are sometimes called "constructive remittances".

Section 833(1) ITTOIA provides:

> For the purposes of section 832, if a person who is ordinarily resident, but is not domiciled, in the UK uses relevant foreign income outside the UK to satisfy a UK-linked debt, the person is treated as receiving the income in the UK at the time when it is so used.

In short, foreign income used to satisfy a UK-linked debt is treated as remitted. There is of course no IT charge on satisfying a UK-linked debt so long as it is not satisfied out of unremitted foreign income. There is no charge on satisfying a debt which is not a UK-linked debt even if it is satisfied out of unremitted foreign income, so long as income is not received in the UK.

9.39.1 *Time of ordinary residence and domicile*

Section 833(1) ITTOIA applies if the person is ordinarily resident in the UK at the time when he repays the debt. It is not necessary that he should be ordinarily resident when the money is lent or when the money lent is received in the UK.

Section 833 applies if the person is not domiciled in the UK when he repays the debt. The section does not apply if he has become UK domiciled at that time. This is consistent with the ordinary RFI remittance basis.[70]

70 See 9.14 (Remittance after acquisition of UK domicile).

9.39.2 *Satisfaction of loan in part*

Section 833(9) ITTOIA provides:

> "Satisfy" in relation to a debt, means satisfy wholly or in part.

9.40 UK-linked debt

The definition is in s.833(3) ITTOIA:

> In subsection (1) "UK-linked debt", in relation to a person, means—
> (a) a debt for money lent to the person in the UK, or for interest on money so lent,
> (b) a debt for money lent to the person outside the UK and received in the UK, or
> (c) a debt incurred for satisfying—
>   (i) a debt falling within paragraph (a) or (b), or
>   (ii) another debt falling within this paragraph.

A debt which is not "for money lent" is not a UK-linked debt; this is a significant restriction, but it is consistent with the principle that remittances of non-money assets are not taxable under the RFI remittance basis. An example of a debt not for money lent is an obligation imposed in divorce proceedings. There is no deemed remittance if foreign income is used to satisfy such a debt as long as the income is not received in the UK.

In the context (foreign loans) "money" clearly includes foreign currency.[71]

All debts for money lent in the UK are UK-linked. A debt for money lent outside the UK is a UK-linked debt only if received in the UK.

9.40.1 *"Received in the UK"*

The question of whether money is received in the UK is decided by applying the RFI remittance basis rules. Section 833(7) ITTOIA provides:

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71 "Money" generally includes foreign currency unless the context otherwise requires: *Mann on the Legal Aspect of Money*, 6th ed., 2005 para. 1.63.

> In subsections (3) to (5) any reference to money lent being received in the UK includes a reference to its being brought there.

This appears to be otiose.

What is received in the UK must be "money". The employment income (and CGT) code provides that earnings (and gains) are treated as remitted (or received) if used or enjoyed in the UK.[72] But there is no equivalent rule here. Suppose:

(1) T borrows outside the UK;

(2) T uses the borrowed money to acquire chattels brought to the UK or UK land (but the money is not received in the UK);

(3) T repays the debt out of unremitted foreign income.

There is clearly no deemed remittance. The same applies even if repayment is made out of unremitted foreign employment income or chargeable gains. However, if the land or chattel is later sold, there is a remittance if the proceeds of sale are received in the UK because at that point the borrowed money is received in the UK.[73]

9.40.2 *"Lent in the UK"*

When is money lent "in the UK" and when is it lent "outside the UK"? The context shows that the answer depends solely on where the money is received when the loan is made. If it is received outside the UK (e.g. credited to an account outside the UK) then it is lent outside the UK. Other UK connections are not relevant. The loan may be made by a UK lender, under UK law, with UK situated security.

A loan is received "outside the UK" even though:

(1) the proceeds are remitted to the UK the next day;

72 See 10.14 (Asset purchased out of employment income enjoyed in UK).
73 See 9.24 (Tracing).

(2) the loan is secured on UK property;[74]

(3) the money lent is used to purchase a UK asset; or

(4) the decision to lend the funds is made in the UK.

If the money is paid direct from a foreign lender to discharge a debt of the borrower in the UK it is arguable that the loan is "lent" outside the UK, but it would be better not to have to rely on that.

In case HMRC take a different view it would be safer to arrange:

(1) a lender is non-resident (or non-resident branch of a UK resident);

(2) a foreign law loan agreement;

(3) the agreement is made outside the UK.

If the money borrowed is used for a qualifying purpose the interest may be deductible against the individual's UK income.

9.41 Basic planning for loans

The legislation draws a distinction between:

1. Money lent to a person in the UK ("a UK loan"); and

2. Money lent to a person outside the UK ("a foreign loan") and received in the UK.

In each case there is a UK-linked debt. But income is treated as remitted if used in satisfaction of the loan or interest on a UK loan. Income is treated as remitted if used in satisfaction of a foreign loan – but not the interest. Why the legislation has made this distinction the author cannot guess.

A basic planning idea, therefore, is as follows:

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74 If the loan is secured on UK land, the security must be governed by UK law, but that would not matter. The security would be relevant in deciding whether the interest had a UK source: see 8.16 (Situs of source of interest).

(a) an individual borrows money outside the UK;

(b) he remits the money borrowed;

(c) he uses foreign income to pay the interest on the loan as it accrues.

This has obvious finance costs but it does avoid any tax charge on remittances. The loan may be repaid without a tax charge:

(1) after the foreign domiciliary has died;[75]

(2) in a year when the foreign domiciliary is not resident in the UK;[76]

(3) in a year when the foreign domiciliary is not ordinarily resident in the UK (even though resident here).

9.41.1 *Converting a UK loan into a foreign loan*

Suppose a foreign domiciliary has borrowed money in the UK and wants to pay the interest out of foreign income. To do so would give rise to an income tax charge under the deemed remittance rules. He should, of course, have borrowed the money abroad. Is there anything he can now do to correct his error? Yes: he can borrow outside the UK and repay the UK debt. He may thereafter pay interest on the foreign loan without a remittance.

9.41.2 *Loan to repay UK-linked debt*

The reader may have thought of the following ingenious arrangement:

(a) The foreign domiciliary borrows money outside the UK ("the first loan") and remits it here.

(b) If the foreign domiciliary were then to use foreign income to repay the

75 See 9.17 (Remittance after death).
76 See 9.16 (Remittance when non-resident).

first loan, there would be a deemed remittance. So instead he borrows abroad again ("the second loan") and uses the proceeds to repay the first loan.

The second loan is not UK-linked under s.833(3)(a) because it is not lent in the UK. It is not UK-linked under s.833(3)(b) because it is not received here. However, it is UK-linked under s.833(3)(c)(i); it is a debt incurred for satisfying a loan under (b), so foreign income used to repay the second loan is treated as remitted.

The individual could borrow a third time abroad and use the proceeds of the third loan to repay the second. However, it would still be UK-linked by s.833(3)(c)(ii).

So no number of new loans will "wash" UK-linked debt status.

Section 833(6) provides:

> For the purposes of this section, if any of the money lent is used to satisfy a debt, the debt for the money so used is treated as incurred for satisfying that other debt.

Money may be borrowed for an entirely different purpose, but if it is in fact used to repay a UK-linked debt, the loan of that money is UK-linked.

9.41.3 *Foreign loan remitted in part*

What if a person borrows money abroad and remits part of it to the UK? On a strict reading the debt is not UK-linked: it is not a debt for money lent outside the UK and received in the UK: it is a debt for money lent outside the UK and *partly* received here. Where the drafter wishes to deal with parts and not the whole, he does so expressly; see s.833(9).

Can the Court fill in the gap by construction? It is not easy to do so: "mixed fund" issues arise. Suppose a foreign domiciliary borrows £4m abroad, remits £2m and repays £1m out of foreign income. Does one say that:

1. This is a remittance of £1m, being the repayment of money brought to the UK; or

2. No remittance, the £1m being the repayment of money kept out of the UK; or

3. A remittance of 50% of the amount repaid?

The answer which makes best sense is probably 3, but that requires reading a good deal into the section which is not there. It is therefore arguable that a foreign loan remitted in part is not UK-linked. However, a Court is likely to take a robust view and apply solution 3, by analogy with CGT,[77] or even solution 2, by analogy with *Duke of Roxburghe*.[78] It is tentatively suggested that solution 3 best fits the scheme of the legislation.

9.41.4 *Loan used to repay UK-linked debt and for other purposes*

At first sight there are anomalies where a foreign loan is used partly to repay a UK-linked debt.

Suppose:

(1) A foreign domiciliary borrows a small sum (say, £1,000) in the UK; a UK-linked debt.

(2) He later borrows a larger sum abroad (say, £1m).

If he uses the £1m to repay the smaller debt, the entire £1m is a UK-linked debt under s.833(3)(c)! So if it is repaid out of foreign income, is there a remittance of £1m even though in reality only £1,000 has been received in the UK? The answer is no, because the second loan, the larger sum, is only incurred "for satisfying" the other debt to the extent that the money is used to repay that debt: s.833(6).

9.42 Foreign loan repaid out of foreign income and proceeds later remitted

Section 833(4)(5) ITTOIA provide:

> (4) In the case of a debt (within subsection (3)(b) or (c)) for money lent to the person outside the UK, it does not matter whether the money lent is received in the UK before or after the income is used to satisfy

77 See 29.5 (Remittance of part of gain).

78 See 9.34 (Remittance from mixture of taxed and untaxed income).

the debt.

(5) But in the case of such a debt if the money lent is not received in the UK until after the income is so used, the person is treated as receiving the income in the UK when the money lent is received there (instead of at the time provided in subsection (1)).

The person must be ordinarily resident in the UK when he receives or brings in the money lent to him outside the UK. He need not be ordinarily resident at the time the loan is made.

9.43 Use of foreign income as security for loans

Section 834(1) ITTOIA provides:

> A person to whom money has been lent ("the borrower") is treated for the purposes of section 833 as using relevant foreign income to satisfy a debt if conditions A and B are met.

Section 834(4) gives "lender" an extended meaning:

> "lender", in relation to money lent, includes any person for the time being entitled to repayment.

In what follows it is assumed that the individual has borrowed from a foreign bank.

9.44 Condition A (the security condition)

Section 834(2) ITTOIA provides:

> Condition A is that:
> [1] the borrower uses the income in such a way that
> [2] the lender holds money or property representing the income on behalf or on account of the borrower
> [3] in such circumstances that it is available to the lender to satisfy the debt (by set-off or otherwise).

An asset is held by a lender *on behalf of* an individual if the lender holds as nominee for the individual. In this case the income is "available" to satisfy the debt if there is a charge or contract to that effect.

Money is held[79] by a lender on *account of* an individual if it acts as a banker, i.e. the money is paid to the lender and credited to the account of the individual (the foreign income account). In this case the foreign income (represented by the account in credit) is normally available to satisfy a debt to the lender,[80] by way of set-off, because:

(1) the bank's standard terms of loan will normally so provide, or

(2) in the unlikely event that the loan agreement is silent on the point, the general banking law will confer a right of set-off (at least if English law principles apply).

It is of course possible as a matter of contract law to arrange that the foreign income is deposited with a bank without a right of set-off for any debt due to the bank.

What if the individual *charges* the foreign income (or property representing it) but it is not "held by the lender"? A chargee is not normally said to "hold" the asset charged. A purposive construction would probably be applied, so this too is caught.

Condition A[1] requires that the borrower *uses* the income in such a way that Condition A[2] and [3] is satisfied. If Condition A[2] or [3] come to be satisfied without income being "used" by the borrower then the security condition is not satisfied.

Example 1
F has over a period of time accumulated £100,000 unremitted foreign income at an offshore bank.
F subsequently borrows £100,000 by overdrawing another account at the same bank and remits this to the UK.

Condition A[2] and [3] are satisfied:

(1) The bank holds the foreign income on account of the borrower.

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79 "Credited" is a more accurate word than "held" since when the foreign income is paid to the lender (as banker) it becomes the property of the lender. But the meaning is reasonably clear.

80 The debt will normally take the form of another account which is overdrawn, but that does not matter.

(2) The foreign income is available to the bank to satisfy the debt by set-off (unless the parties have expressly agreed the contrary).

However, it is considered that Condition A[1] is not satisfied because the individual has not "used" the foreign income.

Example 2
As Example 1 but F expressly agrees that the bank should have a right of set-off.

It is arguable that F has still not "used" the foreign income, but if the bank only lends because F has agreed the right of set-off, that is probably "using" the income.

Example 3
As Example 1, but
– F agrees not to withdraw the accumulated foreign income while the debt is outstanding; or
– F charges the foreign income.

Condition A is now satisfied.

Example 4
F borrows £100,000 and deposits foreign income of £100,000 as security. (The security condition is satisfied in relation to this £100,000 income.) As time passes, (say) £50,000 new income accrues on the deposit and (say) £60,000 interest accrues on the loan.

Condition A[1] is not satisfied in relation to this £50,000 new income as it has not been "used".

9.44.1 *Possible avoidance of Condition A*

Under the terms of Condition A:

(1) the deposit must be held by the lender; if it is held by another person (even a person connected with the lender) the section does not apply.

(2) the security must be given by the individual; the section does not apply

if the individual has settled the income and the trustees make the arrangements.

9.45 Condition B (the linked loan condition)

Section 834(3) ITTOIA provides:

> Condition B is that under an arrangement between the borrower and the lender—
> (a) the amount for the time being owed by the borrower to the lender, or
> (b) the time at which the debt is to be satisfied,
> depends in any respect, directly or indirectly, on the amount or value the lender holds on behalf or on account of the borrower as mentioned in subsection (2).

Suppose the arrangement was that:

(1) an individual deposits a sum in a bank; and

(2) the bank was only prepared to lend up to the value of the sum deposited.

Paragraph (a) of Condition B is plainly satisfied. Suppose however that:

(1) a bank makes a loan to an individual; and

(2) subsequently the individual deposits funds at the bank (on usual banking terms) so the security condition is not satisfied.

In principle paragraphs (a) and (b) of Condition B are not satisfied.

The second aspect of condition B is that these matters are satisfied "under arrangements between the banker and the lender". But "arrangements" is so wide that it is difficult to see what difference this makes.

9.46 Purchase of UK-linked loan

The deemed remittance rule only applies if a UK-linked debt is satisfied. The following arrangement may be considered:

(1) F transfers unremitted RFI to a trust.

(2) The trustees then purchase the benefit of the UK-linked debt from the creditor (usually a bank);

(3) F ceases to pay interest (or interest may be rolled up, unpaid).

The trustees leave the existing loan outstanding.

The foreign income should be paid to an offshore account of the bank. At no time will it be paid to the UK.[81] Thus it is not remitted on the purchase of the loan.

The decision not to charge interest does not in my opinion amount to a remittance of the funds used to purchase the debt. (However, to make the point stronger, interest may be rolled up unpaid on the debt.)

Since the debt remains outstanding, it is not "satisfied". There is no deemed remittance under s.833 ITTOIA.

It is important that there should not be a novation agreement, that is, an agreement (formal or informal) under which the existing debt is satisfied and a new debt is created. Take care over the documentation!

9.47 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.

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.

81 The income may of course be remitted to the UK later by the bank, after it is paid to the bank, but that does not matter.

(2) Section 836 applies so that half the income is deemed to be the income of W.

(3) W is not domiciled in the UK.

It could be argued that W's income being merely deemed income cannot be remitted and cannot be subject to tax; contrast 29.8 (Deemed gains). The consequence is somewhat too good to be true. Following through the deeming, it is suggested that half the income of H is to be regarded as the income of W for the remittance basis, so that if H remits the income, there is a charge to tax on W.

9.48 Avoiding remittances: basic tax planning

The best way to avoid any question of a remittance basis liability is simple and (if the word has any meaning in a tax context) "natural": the income should be retained abroad.

The income should be segregated from capital.[82] The income may be applied to meet the foreign domiciliary's foreign expenditure or it may be reinvested. Capital can be remitted free of income tax. HMRC accept in CG Manual 25410 that this "common practice" is effective.

The income can be used to make gifts to individuals out of the UK or to individuals in the UK so long as the money is received by the donee abroad and not returned to the taxpayer.[83] If the individual prefers not to make gifts, he might make loans.

9.49 Source-ceasing

There is a charge to IT on remitted income only if the income arises in any year from a source in existence during that year. This principle, the source doctrine, was established by the House of Lords in *National Provident Institution v Brown* 8 TC 57.[84] It was derived by a remorseless application

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82 See 9.35 (Remittance from mixture of capital and foreign income).

83 See 9.30 (Transfer of income to third parties completed abroad) and 9.37 (Circular transaction returning income to taxpayer).

84 Post-cessation receipts of a trade were formerly exempt from tax by virtue of this rule: *Stainer's Executors v Purchase* 32 TC 367 and *Carson v Cheyney's Executors* 38 TC 240, which is why there is now a separate charge on post-cessation receipts.

of three rules:

(1) Income tax is not a tax on income of every kind; it is a tax on income *from various specified sources* (formerly Schedules A to F and now the multitudinous categories of charge). In the absence of a source there is no charge.

(2) Income tax is an annual tax. Section 4 ITA provides:

> **4 Income tax an annual tax**
> (1) Income tax is charged for a year only if an Act so provides.

Further:

> Income Tax is ... an annual tax, not only in the sense that it is annually imposed by the Finance Act, but in the sense that it is annual in its structure and organisation.[85]

One should, in principle, treat each income tax year as a separate and independent matter; one must ask in each year whether in that year the conditions of the charge to tax are satisfied.

(3) Income tax was *charged* on income arising in any year from specified sources in that year; it was merely *computed* (under the remittance basis) on sums received in the UK: s.65 ICTA. It was not *charged* on remitted income. Section 65 drew a distinction between a *charge* and a *computation*. A *charge* is the general liability to pay. There will be a charge to tax whenever income arises to a UK resident from a specified source in any year. Once a charge to tax has arisen, the amount of that charge was *computed*. Under the remittance basis the statute does not adopt the natural and accurate means of computation, namely to ascertain arithmetically the amount of income arising from that source. The computation was an artificial one, based on the amount remitted to the UK. The *computation* was subsidiary to the *charge*. If there was no charge to tax then there is nothing to compute. It is irrelevant to compute what the amount of that charge might have been if the conditions of the charging section had been satisfied.

85 *The Luipaard's Vlei Estate and Gold Mining Co v IRC* 15 TC 573.

The conclusion is so extraordinary that, had the House of Lords not decided it (at a time when attitudes to construction of tax statutes were very different), one would not have thought the argument had any prospect of success. In other contexts the principle that income tax is an annual tax is not applied if the result is unreasonable.[86] But there it is. The principle is accepted by HMRC. This was published in the 1988 Consultative Document (Residence in the UK: The Scope of UK Tax for Individuals) paragraph 4.18; and is now published in Inspectors Manual paragraph 1563:

> **Remittance basis: Income that can be excluded**
> Published: 9/95
> Where the remittance basis applies, it is ordinarily immaterial, subject to the guidance in IM 1660–IM 1664, in what year the income arose. Where, however ... the source of the income has ceased before the commencement of the year in which a remittance is made ... such income should be excluded from the computation of liability.

After the ITTOIA rewrite, points (1) and (2) remain. The old distinction between charge and computation also survives, though differently expressed.[87] Other provisions such as those for post-cessation receipts, and s.836(2) ITTOIA, are based on the assumption that the source-ceasing rule still applies. There is an assumption that the Rewrite is not intended to change the law substantially. So the source-ceasing rule still applies.

The source doctrine does not apply to employment income.[88] It does not apply for CGT.

It was suggested some years ago that what is now s.624 ITTOIA might counteract the source doctrine. This is not correct for two independent reasons. Source-ceasing arrangements do not constitute a "settlement", lacking any element of "bounty".[89] Further, the source-ceasing rule applies to s.624.[90] In practice HMRC accept this.

9.49.1 *Planning*

Relevant Foreign Income which is remitted in any year after the source has

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86 See 9.13 (Remittance in tax year after receipt).
87 See 28.4 (Rates of tax on distribution income).
88 See 10.18 (Remittance after employment ceases).
89 See 45.2.3 (Broad definition of "settlement").
90 See 14.8 (Trustees remit trust income to UK).

ceased will not be subject to income tax. The principle offers a practical means of bringing income into the UK while avoiding the remittance basis charge. If a taxpayer "closes down" his sources of income in one year he may remit the income from those sources in the following year.[91]

9.49.2 *Identifying the source*

The first step is to identify the source. In *NPI v Brown*:

> It was argued before us that the source of income was the possession by the Institution of funds for investment, and that such source existed although no funds were invested in the particular manner in the year of assessment. I cannot accept this construction. I think the source to be looked for in each case is a separate source from which the profits to be charged are derived.[92]

In *Grainger v Maxwell's Executors* 10 TC 139 Exchequer Bonds were held to be a different source from War Stock and National War Bonds (though both are similar types of interest bearing security).

In *Turton v Mitchell* 13 TC 248 inherited War Loan was held to be the same source as purchased War Loan.

In *Inchyra v Jennings* 42 TC 388 two interests under the same trust were regarded as having the same source.

For interest on a bank deposit, see 8.15 (Interest: what is the source?).

9.49.3 *Closing the source*

Having identified the source one must arrange that it ceases. In principle a individual's source of income ceases if the source no longer belongs to him, i.e. if it is transferred to another individual, a company, or a trust.[93]

In *Cull v Cowcher* 18 TC 449 the taxpayer agreed to forgo interest on a deposit account, and no interest was paid. The source did not cease. The

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91 For the year of arrival, see 6.5 (Computation in year of arrival).

92 8 TC at p.17. *Diggines v Forestal Land, Timber & Railways Co* 15 TC 630 might seem to indicate the contrary, that Case V sources counted as one source; however, that case (a curious one) was based on statutory wording which has long since been repealed.

93 The source does not cease if the individual who was the former owner retains an interest in possession in a *Baker* type trust.

judge gave two examples:

> If you have a sum of money on deposit, that is, a sum of money which, by the normal contract, produces some interest, and if you transfer that sum of money to current account, that is, to an account where, by the normal usage between banker and customer, no interest is payable, I agree that, in that case, the source, namely, the money on deposit, ceases to exist. It is dried up; there is nothing which can flow from it. If one has money producing interest and one places the money by contract in some position in which it cannot produce interest, I agree that, in that case, there is a cesser of the source; the source ceases, dries up, so to speak. ...
> The learned Attorney-General put to me the case of money lent on a bond or a debenture. Two variants may be put. You may suppose the case where money is lent on a bond or debenture with some special term that interest shall not be paid unless the profits exceed a particular amount, or something of that sort. In that case ... the source would continue although, in that particular year, by reason of the special term, there might be nothing flowing from the source, no money might be received. You may have the other case, also quite possible, where there is a bond or debenture, and the bond holder or debenture holder, being perhaps interested in other ways in the company, agrees to forgo his interest, agrees that interest, to which he is entitled, he will not take. In that case, also, I should think that it is quite clear that the source continues.

9.49.4 *Transfer to settlor-interested trust*

Suppose T transfers an asset to a settlor-interested trust. Section 624 ITTOIA provides that income which arises under the settlement "shall be treated for IT purposes as the income of the settlor and of the settlor alone". This suggests that the source is deemed not to have ceased. But the effect of the s.624 foreign domicile defence is that the trust income does not fall within s.624, so provided that defence applies, as it usually will, it is considered that tax is charged on the (true) basis that the source has ceased, but on the (fictional) basis that the source continues. But the contrary is arguable.

9.49.5 *Transfer to offshore company*

Slightly different points arise if T transfers an asset to an offshore company, whose income he has power to enjoy. Section 624 ITTOIA does not apply.

T is charged on income treated as arising to him under s.720 ITA. In the context of DTTs, HMRC argue that the deemed income under s.720 is not the same income as the income accruing to the offshore person.[94] That seems right. It follows that one cannot argue that, on a transfer to a company within s.720, the source (which has actually ceased) is treated as if it had not ceased. It does not matter whether the s.720 foreign domicile defence applies.

9.50 Source yielding no income

In *Whelan v Henning* 10 TC 263 the taxpayer owned shares in a foreign company and retained the shares, but they produced no income in one year. It was held that no charge could arise in that year under the source-ceasing rule, even though the taxpayer continued to hold the shares throughout the year. The source had not ceased but the same rule applied if the source produced no income! This decision was reversed by (what became) s.71 ICTA:

> Where it is provided by the Income Tax Acts that income tax under Schedule D in respect of profits or gains or income from any source is to be computed by reference to the amount of the profits or gains or income of some period preceding the year of assessment, tax as so computed shall be charged for that year of assessment notwithstanding that no profits or gains or income arise from that source for or within that year.

The effect of this was summarised in the following terms:

> If you have got the source, even though income does not flow from it, you should be liable to assessment.[95]

Section 71 ICTA has been repealed. ITTOIA EN Vol. III explains why:

> 42. Section 71 of ICTA applies to all the Cases of Schedule D when a preceding year basis of assessment applies. It provides that a person will remain chargeable in a year when no income from the relevant source arises. It is based on section 22 of FA 1928 which was enacted in

94 See 32.6 (DTTs and s.720).
95 *Cull v Cowcher* 18 TC 499 at p.454.

> response to the House of Lords decision in *Whelan v Henning*, 10 TC 263 to the effect of no income in year of assessment, no liability to tax.
> 43. There is no longer a preceding year basis of assessment for any Schedule D Case. So the provision is redundant.

The application of s.71 to the remittance basis was overlooked. At present the source-ceasing rule applies if the source yields no income in a year. Perhaps this error will be corrected eventually.

9.51 Foreign income taxable on arising basis: income from Ireland

According to statute, the remittance basis "does not apply to relevant foreign income arising in the Republic of Ireland": see s.831(5) ITTOIA. The reason is historical. The Union with Ireland Act 1800 provided:

> The said Kingdoms of *Great Britain* and *Ireland* shall, upon the first Day of *January* which shall be in the Year of our Lord one thousand eight hundred and one, and for ever after, be united into one Kingdom, by the Name of *The United Kingdom of Great Britain and Ireland*.

"For ever" lasted until the creation of the Irish Free State in 1922. Irish source income would until then have been subject to UK tax on an arising basis. The current provision dates back to the 1926 UK/Ireland Double Tax Treaty and so continued the former position. It might have pleased the framers of the Union with Ireland Act to know that, for some purposes at least, Great Britain and Ireland are even now regarded as "one Kingdom".[96]

The discrimination against Ireland is inconsistent with EU law. The Tax

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96 Not just in the backwater of taxation. Section 2 Ireland Act 1949 provides:

> "It is hereby declared that, notwithstanding that the Republic of Ireland is not part of His Majesty's dominions, the Republic of Ireland is not a foreign country for the purposes of any law in force in any part of the UK ... and references in any Act of Parliament, other enactment or instrument whatsoever, whether passed or made before or after the passing of this Act, to foreigners, aliens, foreign countries, and foreign or foreign-built ships or aircraft shall be construed accordingly."

Eire's Republic of Ireland Act 1948 had broken constitutional links with the Crown, and the UK's Ireland Act 1949 was enacted to ensure that Irish citizens did not lose certain rights in the UK. Post-World War II reconstruction in Britain relied on Irish and Commonwealth citizens; placing barriers to immigration at this time was not a business or political option.

Law Rewrite referred this for policy review[97] but the review was quietly dropped. Perhaps the hope was that no-one would notice the point or do anything about it if they did. Perhaps the intention was to postpone doing anything for as long as possible. But now the EU is acting. IP/07/445 (30 March 2007) provides:

> By a reasoned opinion under Article 226 of the EC Treaty, the European Commission has formally requested Ireland to amend its legislation concerning remittance base taxation. Ireland normally does not tax income received by non-domiciled persons from money invested abroad if the interest is left on the foreign bank account. The Irish legislation excludes from this rule income sourced in the UK and thus treats such income less favourably than income arising elsewhere in the EU. The Commission considers that this is contrary to the EC Treaty and to the EEA Agreement, as it restricts the free movement of capital. If Ireland does not reply satisfactorily to the reasoned opinion within two months the Commission may refer the matter to the European Court of Justice. At the same time the European Commission has decided to send a request for information in the form of a letter of formal notice to the United Kingdom about similar remittance base taxation rules, which in turn appear to discriminate against income sourced in Ireland.
>
> "The Commission does not advocate remittance base taxation, as it may lead to double non-taxation." said EU Taxation and Customs Commissioner László Kovács, "Nonetheless, where it exists, the Single Market requires that it is at least applied in a non-discriminatory manner".
>
> Ireland applies remittance base taxation to foreign sourced income of persons who are not Irish domiciled, or who are Irish citizens who are not ordinarily resident in Ireland.
>
> Remittance base taxation means that income from money invested abroad is only taxed in so far as the income is paid to the State of residence. So, for instance, interest received on a foreign bank account is not taxed, as long as the interest is not paid ("remitted") to the State of residence, but is left on the foreign bank account.
>
> However, Ireland excludes income sourced in the United Kingdom from remittance base taxation. This dissuades non-domiciled and not ordinary residents living in Ireland from investing their money in the United Kingdom. Equally, it is likely to make it more difficult for providers of capital investment opportunities in the United Kingdom to attract capital from these persons. The exclusion of income sourced in the United Kingdom thus constitutes a restriction of the free movement of capital as protected by Article 56 EC and Article 40 EEA. The Commission sees no justification for the restriction.
>
> The Commission also decided to send a request for information in the form of a formal notice to the United Kingdom on its remittance base taxation rules. The

97 Tax Law Rewrite Responses to the 13th Exposure Draft, 12 December 2002, para. 343.

> United Kingdom rules are similar to the Irish, but exclude income sourced in Ireland. The United Kingdom is asked to reply within two months. A letter of formal notice is the first step of the infringement procedure of Article 226 of the EC Treaty.

The notice sent to the UK is confidential, but one can easily imagine what it says. There can be no good answer to it, and reform in the UK is inevitable.

It is suggested that those with Irish source income should only agree to pay tax on a remittance basis, because if they voluntarily pay on an arising basis, it may be more difficult to recover it later. Where tax has been paid on an arising basis which would not have been paid on a remittance basis, a repayment claim should now be made as soon as possible.[98]

9.52 Delayed remittances

Section 835 ITTOIA provides:

> **835 Relief for delayed remittances**
> (1) If section 832 (relevant foreign income charged on the remittance basis) applies to income for a tax year, the person liable for the tax may make a claim for relief under this section in respect of any of the income which meets conditions A and B ("delayed income").
> (2) Condition A is that the income arose before the tax year for which relief is claimed.
> (3) Condition B is that the income could not have been transferred by the person to the UK before the tax year because of—
> (a) the laws of the territory where the income arose,
> (b) executive action of its government, or
> (c) the impossibility of obtaining there currency that could be transferred to the UK.
> (4) If a person claims relief for a tax year in respect of delayed income, that income is to be deducted from the income charged to tax for that year in accordance with section 832.
> (5) The delayed income is to be treated as if it were income received in the UK in the tax year in which it arose.[99]

The effect of the relief is that the income will be taxed in the year that it

98 For the limitation period see s.106 FA 2007.
99 Section 279 TCGA has equivalent rules for CGT.

arose (even though it was not remitted in that year): it will not be taxed in the year of remittance. The relief for delayed remittances will not often be claimed, because it will not normally make any difference. The relief might be useful to a taxpayer who pays tax at the basic rate in the earlier year, but the higher rate in a later year. It might also be useful in the exceptional case where an individual has a claim for loss relief in the earlier year. The relief was introduced in 1956, when the problem of "bunching" caused by delayed remittances was much more serious.

Section 836 ITTOIA contains provisions relating to pensions granted retrospectively; section 837 ITTOIA sets out administrative provisions relating to the claims. These sections are not set out here because the relief is of very little importance.

9.53 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 income and gains within the remittance basis. UK sources of 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.[100]

In the first edition of this book I said:

> It is likely that publication will stop the practice completely. Those who

100 Transition from taxation by agreement to taxation by law raises additional problems discussed in Malcolm Gunn's article.

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*.[101] 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.

101 *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

EMPLOYMENT INCOME

10.1 Introduction

ITEPA imposes charges to income tax on:

(1) employment income, subdivided (in short) into:

(a) general earnings (the term includes benefits in kind);

(b) specific employment income (not discussed here);

(2) pension income (discussed at 11.1 (Foreign pensions);

(3) social security income.

Double tax relief may also need consideration but this is not considered in this book. For NICs see 20.1 (NIC).

10.2 Resident, ordinarily resident and foreign domiciled employee

Section 21 ITEPA imposes a charge on an arising basis on the "general earnings" of an employee who is UK resident and ordinarily resident but foreign domiciled:

> except to the extent that they are chargeable overseas earnings for that year.

Section 22 ITEPA imposes a charge on a remittance basis on chargeable overseas earnings (formerly Schedule E Case III):

> **Chargeable overseas earnings for year when employee resident and ordinarily resident, but not domiciled, in UK**
> (1) This section applies to general earnings for a tax year in which the employee is resident and ordinarily resident, but not domiciled, in the UK to the extent that the earnings are chargeable overseas earnings for 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...

10.3 Chargeable overseas earnings

The expression "chargeable overseas earnings" imposes two sets of requirements: there 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) in that year the employee is resident and ordinarily resident, but not domiciled, in the UK,
> (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 for associated employments.

10.4 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—
> (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, ...

10.4.1 *Foreign employer: HMRC practice*

EI Manual paragraph 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 under section 21. 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.

10.4.2 *Employer resident in Ireland*

The remittance basis does not apply if the employer is resident in Ireland. This is achieved by the drafting technique of saying that an Irish resident employer of a UK resident employee is not a "foreign employer". That might surprise the residents of Eire. The rule is consistent with that applied to foreign investment income: see 9.51 (Income from Ireland).

10.5 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. IR20 provides:

> 5.7 Whether duties you perform in the UK are "incidental" to your overseas duties depends on all the circumstances. If the work you do in the UK is of the same kind as, or of similar importance to, the work that you do abroad, it will *not* be merely incidental unless it can be shown to

be ancillary or subordinate to that work. It is normally the nature of the duties performed in the UK rather than the amount of time spent on them that is important, but if the total time you spend working in the UK is more than 91 days in a year, the work you do will not be treated as incidental.

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 40203:

> 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.[1]

1 [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 any 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.

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 25. 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, 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".[2]

This approach is also consistent with the 1955 Royal Commission which gave two examples of incidental duties: "returning for report" and "to collect samples, etc".[3]

Tax Bulletin 76 suggests that this will be the basis of an attack on dual employment contract planning:

> 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

2 The gist of this is also set out in IR20 paras. 5.7–5.8.

3 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.

10.6 Dual contract arrangements[4]

Tax Bulletin 76 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

4 Alistair Ladkin has written a valuable article on this topic in *Taxation*, Vol. 150, No. 3900, p.632 (27 March 2003).

performed in the rest of the world, excluding the UK.
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 10.5 (Where are duties performed: incidental duties).

(3) Apportionment arguments (see below).

10.6.1 *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.[5] The conclusion can be defended on the basis of *IRC v Scottish*

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5 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;

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

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(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 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)

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 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; see 20.1 (NIC).

10.6.2 *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.

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 21(1).

10.6.3 *Implications for employer*

Inspectors Manual para. 5348 provides:

> 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 split contract arrangements.

10.6.4 *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).[6]

This statement was made before the Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regs 2006, though it is still valid under the current law. It is interesting that the statement describes dual contract arrangements as "everyday" and "standard".

10.7 Resident but not ordinarily resident employee

Sections 25 and 26 ITEPA provide:

> **25 UK-based earnings for year when employee resident, but not ordinarily resident, in UK**
>
> (1) This section applies to general earnings for a tax year in which the employee is resident but not ordinarily 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...
>
> **26 Foreign earnings for year when employee resident, but not ordinarily resident, in UK**
>
> (1) This section applies to general earnings for a tax year in which the employee is resident, but not ordinarily resident, in the UK if they 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.
>
> (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....

6 Statement to CIOT accessible *www.tax.org.uk/showarticle.pl?id=2704*.

This imposes:

(1) a charge on an arising basis on general earnings in respect of duties performed in the UK; and

(2) a charge on a remittance basis on other earnings.

This is better than the remittance basis for UK resident and ordinarily resident foreign domiciliaries:

(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 have dual contract arrangements.

10.8 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.

This applies regardless of domicile.

10.9 "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 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.[7]

EIM 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 Section 25 that excluded salary attributable to the days of absence. The Inspector successfully contended that Section 38 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 Section 25.

10.10 Earnings "in respect of" duties performed in the UK

SP 5/84 para 2 states:

7 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.

> 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 now the Revenue have 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 emoluments attributable to UK duties would be 200/250.

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.

10.11 Summary

The taxation of employment income can be summarised in this table:

UK Resident	Ordinarily Resident	UK Domicile	Scope of charge	Charging Section
Yes	Yes	Yes	All earnings: AB	15
Yes	Yes	No	(1) chargeable overseas earnings: RB (2) other earnings: AB	21 22
Yes	No	irrelevant	(1) UK duties: AB (2) other duties: RB	25 26
No	irrelevant	irrelevant	(1) UK duties: AB (2) other duties: tax free	27 –

Key AB: Arising basis RB: Remittance basis

10.12 Claims

No claim is required: the employment income remittance basis is compulsory. This is probably deliberate as there are few circumstances where a taxpayer would wish *not* to make a claim. Contrast the RFI remittance basis; see 9.9 (Claims).

10.13 Meaning of "remitted to the UK"

Section 33 ITEPA provides:

> **Earnings remitted to UK**
> (1) This section explains what is meant for the purposes of this Chapter by general earnings being remitted to the UK.
> (2) 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 paragraph (b).

Subsection (2) (which dates back to 1956) is perhaps intended to extend the concept of "remittance" beyond that which applies for the 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.)

Most of the principles of the RFI remittance basis apply to the employment income remittance basis. In particular the principle of *Carter v Sharon* 20 TC 229 applies, with the result that income transferred abroad to others may be remitted by them to the UK without any charge to tax.

The EI Manual provides at 40302:

> *Paid in the UK*
> 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.

This is correct. The Manual continues:

> 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.

This conclusion is correct, though the statement that the money has "been in the banking system" is layman's language.[8]

10.14 UK situate asset purchased out of employment income

10.14.1 *UK asset used or enjoyed in UK*

If employment income is applied in the purchase of chattels which are brought to the UK and used by the employee, the income is "used or enjoyed in the UK" and so is treated as remitted. HMRC agree. EI Manual 40302 provides:

> *Assets*
> 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.

This is also supported by an *obiter* comment in *Grimm v Newman* [2002] STC 1388, at [100]–[101]. Contrast the RFI remittance basis.[9] The same would apply if the earnings are applied in the purchase of a house occupied by the employee.

10.14.2 *UK asset not used or enjoyed*

What is the position if employment income is invested in UK situate property which is not enjoyed *in specie*? For example, if it is invested in UK situate shares or land let as an investment or a house not occupied by the employee (e.g. perhaps occupied by his children)? Assume that the income itself is not received in the UK (because payment for the asset is made to the vendor outside the UK).[10] It would be arguable the income has been "brought to the UK" in some "manner or form", so there has been a remittance. However, it is considered that income is only remitted if the individual actually uses or enjoys the assets, and merely holding UK situate

8 See footnote to 9.27 (Foreign income from bond or coupon in UK).
9 See 9.28 (Chattels brought to the UK).
10 See 9.30 (Transfer of income to third party completed abroad).

assets is not enough.[11] The specific reference to *chattels* in the EI Manual suggests that HMRC adopt this view. In practice this 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.

10.15 Services paid for out of employment income

What is the position if employment income is used to pay a debt for services received by the individual? Assume that the income itself is not received in the UK (because payment is made to a foreign account of the creditor). It is considered that the income is not enjoyed in the UK. It has been used to pay a UK debt, but the debt is not within the deemed remittance rules (discussed below) because it is not a debt "for money lent". The deemed remittance rules show that payment of such a debt is not a remittance (or the statutory rule would not be necessary). I have considered whether the income is "enjoyed in the UK" on the grounds that it is paid in consideration of services, if the services are enjoyed in the UK. But this is not correct, since there is no remittance when the services are performed. The payment of the income does not amount to enjoyment of the income in the UK. Any rule that a payment for services in the UK constituted a remittance would be unworkable. A rule of this kind would require one to identify what are "UK services". But there is no obvious answer to that, and any rule would have to be somewhat arbitrary. VAT, for instance, has complex and somewhat arbitrary statutory rules in s.7 VATA 1994, but there is no possible basis to incorporate those rules into the income tax legislation (which was enacted almost two centuries before the VAT legislation).

The VAT element on fees is not itself a liability of the client: it is just part of the fees.[12] So payment of VAT on fees is no different from payment of any other part of the fees.

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11 If this were wrong then s.33(2)(a) ITEPA would be otiose since chattels used or enjoyed in the UK must be UK situate. Also if that were wrong, there would be a remittance under the CGT remittance basis whenever a UK resident foreign domiciliary places sterling in a foreign bank account, as the account is regarded as UK situate for CGT: see 47.10 (Bank account).

12 See *Glenrothes Development Corpn v IRC* [1994] STC 74.

10.16 Deemed remittances

Sections 33, 34 ITEPA contain deemed remittance rules almost identical to the RFI rules discussed at 9.39 (Deemed remittances). There are two differences.

(1) The employment income rules apply if the employee is ordinarily resident in the UK. The RFI rules apply if the individual is "ordinarily resident, *but is not domiciled* in the UK".

(2) The RFI deemed remittance rules do not apply to someone who has become UK domiciled, but the ITEPA deemed remittance rules still apply. This is consistent with the general rule of employment income.[13]

10.17 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": ss.22(3)(a), 25(3)(a) and 26(3)(a) ITEPA.

10.18 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)(b), 25(3)(b) and 26(3)(b) ITEPA. This may be contrasted with the RFI remittance basis: see 9.49 (Source-ceasing principle).

10.19 Earnings for non-UK resident year

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.

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13 See 10.21 (Remittance after acquisition of UK domicile).

10.20 Remittance when not UK resident

Suppose:

(1) In year 1, an individual has unremitted chargeable overseas earnings for a year.

(2) In year 2, the individual is not UK resident and remits the earnings.

Section 22(2) ITEPA taken at face value states that the remitted earnings are taxable earnings in year 2. It is doubtful whether that odd result can be correct.

10.21 Remittance after acquisition of UK domicile

Where:

(1) A foreign domiciliary retains chargeable overseas earnings abroad,

(2) acquires a UK domicile, and

(3) subsequently remits the income,

the income is still taxable. Contrast the position for the RFI remittance basis; see 9.14 (Remittance after acquisition of UK domicile).

10.22 Remittance after death of employee

The drafter has also provided for this case. If personal representatives receive chargeable overseas earnings in the UK, there is a tax charge on them: s.13(4) ITEPA. If they receive emoluments out of the UK and assent to beneficiaries, there is no charge.

10.23 Remittance out of earnings for mixed UK/foreign duties

SP 5/84 explains:

Employees resident but not ordinarily resident in the UK: general earnings under ITEPA 2003 ss.25, 26

1 Employees who are resident but not ordinarily resident in the UK are liable to UK tax under ITEPA s.25, on general earnings wherever received for duties performed in the UK. They are also chargeable under ITEPA s.26 on general earnings for duties performed outside the UK but only to the extent that the earnings are general earnings remitted to the UK.

...

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.25, and only any balance out of general earnings chargeable under s.26 on remittance.[14]

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.

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.25 and 26, in respect of general earnings from that employment; and
(c) receive part of their general earnings in the UK and part abroad.

In such cases, provided the general earnings chargeable under s.25 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.25 for that year; and to restrict the charge under s.26 to the excess of the aggregate over the charge under s.25.

14 [Author's note] This is arguably correct in law and not a concession: see 9.34 (Remittance from mixture of taxed and untaxed income).

10.24 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 whether the payment may give rise to CGT, but it may be that in practice HMRC do not take that point.

10.25 Overseas Crown employment

General earnings from overseas Crown employment subject to UK tax[15] are taxed on an arising basis regardless of residence and domicile and place of work. The reason is given in the 1955 Royal Commission Report:

> 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 servants abroad is fixed with these considerations in mind.[16]

10.26 PAYE and NIC

The PAYE and NIC rules are modified for employees paid on a tax equalisation basis. See Tax Bulletin 81.

10.27 Benefits in kind

This is discussed in 42.7 (Family home: benefit in kind charge) and 42.33 (Chattels held by companies) as the most important issues relate to the family home and its chattels.

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15 The expression "general earnings from overseas Crown employment subject to UK tax" is defined in s.28 ITEPA.

16 Cmd. 9474 para 307.

10.28 Seafarers

The special 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 4.13 (Seafarers).

CHAPTER ELEVEN

FOREIGN PENSIONS

11.1 "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.

11.2 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

1 Section 574 ITEPA extends the meaning of pension to include voluntary pensions, to reverse the decision in *Stedeford v Beloe* 16 TC 505.

pensions: s.575(2) ITEPA provides:

> 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: see 9.9 (Claims).

11.3 Irish pensions

By statute, Irish source income of a foreign domiciliary is taxed on an arising basis, not the remittance basis: but see 9.51 (Foreign income taxable on arising basis: income from Ireland). The 10% deduction referred to in the above paragraph applies. The UK/Ireland DTT also needs consideration.

11.4 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.
15063. Overseas schemes: ESC A10 – Text [December 2005]

The Manual sets out the ESC and continues:

- 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 TWELVE

TRADING[1] INCOME

12.1 UK resident trader rules

The provisions for resident and non-resident traders are different and need to be considered separately. For all traders, s.5 ITTOIA provides:

> **5 Charge to tax on trade profits**
> Income tax is charged on the profits of a trade, profession or vocation.

For UK residents, s.6 ITTOIA provides:

> **6 Territorial scope of charge to tax**
> (1) 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).

The RFI remittance basis applies to trading income of a UK resident foreign domiciliary which 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:

1 In this chapter, reference to a "trade" includes a profession or vocation as there is no relevant distinction between them.

> 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.[1] 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.[2]

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 examples seen of Case V trades were those in which a company is a partner in

1 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*.

2 See 10.5 (Where are duties performed: incidental duties).

> 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 almost 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. ...

12.1.1 *Planning for UK resident sole trader*

If a UK resident 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

12.2 To whom does trading income accrue?

Since different rules apply depending on whether trading profits arise to a UK or non-UK resident, it is necessary to identify the person to whom the profits arise.

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 section 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 but that is not trading income. However, the s.720 foreign domicile defence applies only to income which would not be chargeable if the individual had received it.[3] So for the purpose of the defence one must apply the UK resident trader rules.

12.3 Non-resident trader rules

An entirely different rule applies to *non*-resident traders. Section 6(2)

3 See 16.14 (s.720 foreign domicile defence).

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?

(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 do not arise. But of course that is not always the case. The ITH discourses eruditely (as always).[4]

12.4 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 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

4 Tax Bulletin 18 provides a brief summary not set out here.

> 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; see 12.14 (Trading in UK: preparatory and auxiliary activities).

12.5 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 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 United Kingdom. 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.

12.6 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[5] 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 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.'

12.7 Where profits in substance arise

So we turn to the question of where profits in substance arise. The ITH provides:

> **820. General**
>
> 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. 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

5 I guess that this passage in the ITH was written in the 1980s.

> 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. ...

Trades vary so widely that it is not possible to devise a single test that fits all trades. The comments made at 8.16.2 (Unsatisfactory approaches to identifying source of interest) apply here too.

12.8 Buying and selling

The ITH continues:

> **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 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).

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.[6]

12.9 Services

The ITH continues:

> **823–825.**
> **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.

6 [1992] STC 723 at p.729.

In *Brackett v Chater*,[7] a surveyor contracted himself to a Jersey property development company (incidentally owned by a Jersey trust that Brackett had settled 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.

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.

12.10 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].

12.11 Manufacturing and selling

The ITH 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 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

7 60 TC 134 & 639.

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.[8]

12.12 Leasing and licensing tangible property

The position for property income from land is governed by statute and case law is irrelevant for UK tax.[9]

What about leasing[10] chattels (e.g. pictures)? It is helpful to consider trading and non-trading cases separately.

12.12.1 *Leasing chattels without trading*

If there is a simple lease (without a trade) the source of the income is the 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

8 [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.

9 See 13.1 (Property income).

10 References to leasing in this paragraph include licensing: there is no material distinction for our purposes.

> letting property ... the profit will have arisen in or derived from the place where the property was let ...[11]

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.[12]

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 because the IHT/CGT situs rules are also different for such assets.

12.12.2 *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.

12.13 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

11 [1990] STC 733 at 740b.
12 [1992] STC 723 at p.729e.

> 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.[13] The ITH continues:

> The above cases are straightforward enough but difficulty starts to 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 unfortunate 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.

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13 "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.

This is right because it is difficult to allocate the profits, so they should be regarded as merely auxiliary.[14]

> 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.

12.13.1 *Services conducted in different places*

In *Yates v GCA International*[15] 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 s.790 ICTA provides 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. The ITH comments:

> 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.

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.

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14 See 12.14 (Trading in UK: Preparatory and auxiliary activities).

15 64 TC 37.

12.14 Trading in UK: Preparatory and auxiliary activities

The ITH para.849 provides that activities within OECD Model Convention para 5(4) do not amount to trading in the UK. Para.5(4) provides:

> 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 subparagraphs 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 12.22 (PE: preparatory and auxiliary activities).

12.15 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[16] 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:

(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 a set of circumstances which may not lend themselves to that analysis.[17]

There is no case law on email acceptance. 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. 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

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16 Further consideration is needed if the applicable law is not English law.

17 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 297.)

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.

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.[18]

12.16 Relevance of Commonwealth trading cases

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*[19] (New Zealand); *Maclaine v Eccott*[20] (England); *Studebaker Corporation of Australasia v CT*[21] (Australia); and two South African cases, *CT v William Dunn & Co*;[22] and *Overseas Trust Corporation v CIR*.[23]
>
> 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:

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18 There is also a brief comment (not worth setting out here) in NI Manual 29013.
19 [1908] AC 46.
20 [1926] AC 424.
21 (1921) 29 CLR 225.
22 (1918) SALR (AD) 607.
23 (1926) SALR (AD) 444.

> [3] If the charging words of the English statute[24] 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*,[25] 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.[26]

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.[27] 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.[28] In an Indian statute, the charge was on profits "accruing or

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24 The reference is to what became s.18 ICTA, now recast in a different form in ITTOIA.

25 3 TC 407.

26 [1940] AC 774 at p.788-9.

27 See 12.1 (UK resident trader rules).

28 *IRC v HK-TVB* [1992] STC 723 at p.728.

arising in British India". This was held to be substantially the same as in Hong Kong.[29] Likewise in s.790 ICTA which provides relief for foreign tax on "income arising in" the foreign territory, the principles of *Smidth* and *Hang Seng Bank* were applied to determine whether income arose in Venezuela.[30]

Unfortunately the Commonwealth cases are remarkably inconsistent.[31]

12.17 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

29 *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."

30 *Yates v GCA International* 64 TC 37.

31 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.

> 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".[32]

ITH also touches on this issue:

> **814. Measure of profit in *Erichsen v Last*[33]**
>
> 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.

12.18 Why does permanent establishment matter?

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 (though the PE may be relevant for a DTT and may constitute a branch or agency).

It is not possible to set out a complete list of the significance of PE for non-resident companies, but the following are the most important. In the

32 [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 Establishments accessible *www.oecd.org/dataoecd/55/14/37861293.pdf.*

33 [Author's note] For facts of *Erichsen v Last* see ITH 813, set out in 12.5 (Place where contract made).

absence of a PE, the company is subject to income tax on its income in accordance with the rules set out above and is not subject to CGT. If there is a PE, the company is subject to corporation tax under s.11 ICTA:

> **Companies not resident in UK**
> (1) A company not resident in the UK is within the charge to corporation tax if, and only if, it carries on a trade in the UK through a permanent establishment in the UK.
> (2) If it does so, it is chargeable to corporation tax, subject to any exceptions provided for by the Corporation Tax Acts, on all profits, wherever arising, that are attributable to its permanent establishment in the UK.[34]
> These profits, and these only, are the company's "chargeable profits" for the purposes of corporation tax.
> (2A) The profits attributable to a permanent establishment for the purposes of corporation tax 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]—
> (i) by virtue of assets being used in or for the purposes of the trade carried on by the company through the establishment, or
> (ii) by virtue 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.

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

34 Section 11AA ICTA (not discussed here) defines the profits attributable to a PE.

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. Lastly, PE of a corporate trustee is relevant to trust residence.

12.19 Meaning of permanent establishment

The definition of PE needs a book to itself.[35] The following is a brief introduction to the subject.

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 IHT Manual calls domestic law PE), defined in s.148 FA 2003.[36]

(2) Treaty PE. The definition of PE in DTTs varies in different treaties, but the definition in the OECD Model usually attracts the most attention.

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.

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35 See [2006] BTR at p.722.

36 Section 832(1) ICTA provides:

"'permanent establishment', in relation to a company, has the meaning given by section 148 of the Finance Act 2003."

> 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 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. It is best to consider them separately.

12.20 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 ...

The OECD Model is substantially the same: article 5(1).

INTM para.264060 discusses domestic PE but that merely repeats and refers to the INTM discussion of Treaty 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.

12.20.1 *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.

12.20.2 *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 paragraph 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.

12.20.3 *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).

12.20.4 *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;[37]
> (c) an office;
> (d) a factory;
> (e) a workshop;
> (f) an installation or structure for the exploration of natural resources;[38]
> (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)[39] make it clear that this is not an exhaustive list of the places that could be a permanent establishment.

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

37 See 12.26.2 (Meaning of "branch").
38 This is not in the Model treaty.
39 The text erroneously reads: 5(1).

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.

12.20.5 *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.[40]

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 period of duration 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 paragraph 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 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

40 Contrast the narrower OECD Model article 5(3) where the building site (etc) constitutes a PE only if it lasts more than 12 months.

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.

12.21 Agency

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:

Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 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, unless the activities of such person are limited to those mentioned in paragraph 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.

(Emphasis added)

The ITH provides at para 851:

> Treaties following the example of the OECD Model are influenced by the civil law concept of agency. Paragraph 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 paragraph 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’.

12.21.1 *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 paragraph 45 and in 1994 a sentence was added to the commentary itself at paragraph 32 confirming that this is now the accepted interpretation.

The INTM discussion of Treaty 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 paragraph 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.

12.21.2 *Independent agent*

Section 148(3) 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.

The INTM comments on s.148(3)at 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:

> Paragraph 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 paragraph 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 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. ...
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), paragraph 32.1 of July 2005 version).

12.22 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 Treaty 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 Model explains the reason for the exemption for collecting information:

> The reference to the collection of information in subparagraph 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".

12.23 Alternative finance arrangements

Section 148(5A) (5B) FA 2003 deal with alternative finance arrangements, and are not discussed here.

12.24 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.

12.25 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.

The existence of the branch or agency has consequences:

(1) The tax may be collected from the branch/agency: chapter 1 part 14 ITA.

(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.

12.26 Meaning of "branch or agency"

12.26.1 *The statutory 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).
>
> (Paragraphing added)

For the purposes of s.126 FA 1995, the term is likewise defined to mean "any factorship, agency, receivership, branch or management" (though without the restriction for general agents and brokers).

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.[41] The INTM expresses the same point more tactfully:

41 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 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

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".[42] This is not particularly helpful so we must look for authority elsewhere including case law.

12.26.2 *Meaning of "branch"*

The ITH states at 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 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 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.

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assessable and chargeable in the name of the factor, agent, receiver, branch or manager."

42 [Author's note.] The reference should be s.126(8) FA 1995. However, the definition there is the same, so it does not matter.

12.26.3 *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.

12.26.4 *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*,[43] 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

43 60 TC 134 & 639, at 646.

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.[44] 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 very often the branch will also 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 at least 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 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:

44 "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."

> 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*, and rather a sweeping generalisation. 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.

12.26.5 *Exception for general agents*

Section 10(6)[b] TCGA provides:

> 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! It is suggested that this should be taken as a reference to the replacement legislation, now in the ITA.

12.26.6 *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.[45]

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.

12.27 Asset ceasing to be chargeable asset

Where an asset ceases to be a chargeable asset, e.g. if the business ceases, or if it becomes situated outside the UK, it is deemed to have been disposed of at market value, thereby crystallising any inherent capital gain: the gain is restricted to the increase in value since 14 March 1989. In some cases this is clearly overridden by EU law.

However, these rules can easily be avoided. The business, including chargeable assets, could be transferred to a company as a going concern in exchange for shares and relief claimed under s.162 TCGA so that the gain is rolled into these shares. This would enable the non-resident to sell the shares in the company free of tax. Section 10 would have no application in these circumstances. Such a plan is subject to the possible application of the *Ramsay* principle, especially if the company does not retain the business which is acquired for very long. With this in mind, the transfer to the company should be made before the vendor has found a purchaser for the asset, or at least before the purchaser has committed himself to the purchase.

12.28 Partnership income: remittance basis[46]

Each partnership is a separate source. The source will cease to exist if the partnership is wound up, even though the individual may continue to be a member of another partnership. The ITH provides at 1618:

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45 REV BN 25 para 8 (17 April 2002).

46 See too 4.36 (residence of partnership).

> The remittance basis [for UK domiciled individuals] lasted until 1974. If the [partnership] profits were kept abroad we could not tax them and often did not know there was a partnership. If the partnership was wound up – so that the Case V source ceased – and the accumulated profits were not remitted until the following year even the remittances escaped tax. Until 1965 companies could join in the fun although the very high rates of individual taxation meant that the remittance basis was more attractive to individuals.

It is sometimes advantageous to operate two partnerships, one in the UK, and one abroad (receiving income for trading outside the UK). In these cases the question arises whether two partnerships exist or one; and if two, what is the income of each? These issues are discussed in ITH 1623–1625 (not set out here).

Section 857 ITTOIA provides:

> **857 Partners to whom the remittance basis may apply**
> (1) This section applies if—
> (a) a firm carries on a trade wholly or partly outside the UK,
> (b) the control and management of the trade is outside the UK, and
> (c) a partner who is a UK resident individual—
> (i) meets condition A or B in section 831 (conditions to be met for income to be charged on the remittance basis), and
> (ii) makes a claim to that effect for a tax year.
> (2) The partner's share of the profits of the trade arising in the UK is determined in accordance with sections 849 to 856.
> (3) The partner's share of the profits of the trade arising outside the UK is treated as relevant foreign income for the purposes of this Act (see Part 8).

In short, the partnership income of a UK resident foreign domiciled partner qualifies for the remittance basis if:

(1) The trade is carried on wholly or partly outside the UK.

(2) Control and management of the trade is outside the UK.

If the trade is carried on partly in the UK, there is an apportionment to determine the profits arising in/outside the UK.[47]

ITH 1605 summarises the position thus:

> Where the control and management of a business carried on in partnership is abroad, the partnership is deemed to reside outside the UK and the extent to which there is liability under Case I/II is determined as if the business were carried on by non-residents even though some partners are resident. This means that if the activities in the UK would not amount to trading in the UK by a non-resident, as described in chapter 8, then there is no Case I liability. Thus if the partnership merely purchases goods here or carries on some other part of the operations which fall short of trading in the UK by a non-resident there is no Case I. If the activities amount to trading in the UK even by a non-resident, the Case I liability is restricted to the profits arising here. ...

12.28.1 *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 drawn from case law on company residence, and it is considered that it should be given the same meaning here. Thus the company residence case law gives guidance.[48] ITH provides at paragraph 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

47 See 12.17 (Apportionment).

48 There is a discussion in the ITH at 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 the references at 4.35 (Residence of trusts and companies).

> 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?

The ITH continues with another interesting point at 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.

CHAPTER THIRTEEN

PROPERTY INCOME

13.1 Terminology

ITTOIA uses the term "property income" to mean income from land.[1] The key expressions are "UK property business" and "overseas property business". Sections 264, 265 ITTOIA provide the starting point for these two definitions:

> **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 in the UK, and

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."

> (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.

ITTOIA continues:

> **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.

(But see below for an important refinement to the definition of "overseas property 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 United Kingdom. That is the only difference between a UK and an overseas property business: income from land outside the United Kingdom can arise only in an overseas property business; income from land in the United Kingdom 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.

13.2 Taxation of income from overseas property business

There are two charging regimes: Chapter 3, Part 3 imposes an arising basis and Chapter 11 sets out the remittance basis. The arising basis provisions are as follows:

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.
(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.

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).

Chapter 11 sets out the remittance basis:

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).

We are now in a position to understand s.263(4)(5) ITTOIA which restricts the meaning of "overseas property business":

(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 ...
(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.

Thus there are three types of property business:

(1) UK property business (not discussed here).

(2) Offshore property business (taxed on arising basis under Chapter 3).

(3) Offshore property business *not* taxed under Chapter 3, i.e.:
  (a) business owned by foreign domiciliary (taxed on remittance basis).
  (b) business owned by non-resident (not taxed).

Statute does not provide a name for category (3); confusingly, (a) and (b) are not within the restricted definition of "overseas property business". I refer to them as a "non-qualifying offshore property business".

13.3 Losses of overseas property business

Chapter 4 part 4 ITA provides loss relief for an overseas property business.
In particular, s.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….

The significance of the restricted definition of "overseas property business" in s.263(4) ITTOIA is that this loss relief is restricted. If the business is not "an overseas property business" (i.e. it is a non-qualifying offshore property business) when the loss accrues, the loss is not allowable at all. 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.

13.4 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 United Kingdom 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.

CHAPTER FOURTEEN

SETTLOR-INTERESTED TRUSTS

14.1 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.

14.2 "The settlor"

On the definition of "settlor" see 45.1 (Who is the settlor?).

14.3 "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.

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1 The context suggests this is an exhaustive definition, i.e. the word "include" really means "mean".

The points made in 15.15 (The amount of income of person abroad) and 15.14 (Capital receipt deemed to be income) apply also for the purposes of ascertaining what is the "income arising under a settlement".

14.3.1 *Is income of company held by trustees "income arising under a settlement"?*

Income arising to a company held by trustees (not arising to trustees directly) 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 such income into the scope of that expression).[2] This conclusion is also supported by reference in the definition to "income chargeable to income tax". Income arising to a company would normally be chargeable to corporation tax. Company income may fall within the transfer of asset provisions discussed in the following chapters.

It is suggested that the same applies to income of a unit trust held by trustees.

14.3.2 *Is income of life tenant (not the settlor) "income arising under a settlement"?*

Income payable under the trust to a life tenant is "income arising under a settlement". Admittedly, such income is usually regarded for tax purposes 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 45.2.3 (Broad definition of "settlement").

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

2 This was part of the repeal of the close company apportionment provisions, by a Government which paid more than lip service to tax simplification.

3 See 8.18.1 (Interest in possession type trusts).

argued that such income falls outside the scope of s.624 ITTOIA.[4]

14.3.3 *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.[5] But from 2006/07 the rates of tax are the same in either case,[6] so the issue does not now arise.

14.3.4 *Property income*

Property Income Manual 1045 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).

In particular it follows that interest paid by the trustees is in principle deductible. The 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.

The Manual continues:

> 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

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4 This is also supported by the wording of s.689A(1) ICTA.

5 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.

6 See 28.5 (Rates of tax on settlor).

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.

14.3.5 *Gains from life policies and offshore funds*

See:

(1) 21.5 (Section 624 ITTOIA and life policies);

(2) 22.8.2 (UK resident settlor-interested trusts) and 22.9 (Non-resident trust holding offshore funds).

14.4 "Settlor-interested"

14.4.1 *The concepts of "settlor-interested"*[7]

The term "settlor-interested", first coined in the FA 2000, is used in

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7 In addition, "power to enjoy" for s.720 ITA is a very similar concept, with a different label. GWR is a comparable but not identical concept.

connection with three different provisions:

(1) The IT settlement provisions (discussed in this chapter).

(2) Section 77 TCGA (UK resident trusts).[8]

(3) Section 86 TCGA.[9]

Consistent with the patchwork nature of UK tax, these three provisions have significant differences, though they share a common framework. "Settlor-interested" is a convenient label, but not a wholly accurate one.

14.4.2 *"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[10] 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, and no doubts or questions arise.[11]

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.

By contrast, the question for CGT is whether the settlor has an interest

8 See 30.16 (UK resident settlor-interested trust)

9 See 30.3 (The s.86 charge)

10 "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.

11 For further discussion see *Drafting Trusts & Will Trusts*, James Kessler QC, 8th ed., Chapter 13.

in the *settlement*. So if the settlor is excluded from part of the trust fund the CGT provisions apply to the entire settlement.

14.4.3 *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 section 624 only on the income arising from the part in which he still has an interest.

14.4.4 *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: see 45.7 (Transfer from trust A to trust B by exercise of trustees' power).

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.

14.5 Rates of tax on settlor

See 28.5 (Rates of tax on settlor).

14.6 Section 624 foreign domicile defence

Section 648 ITTOIA provides a defence to the settlor-interested trust charge. It 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 then continues:

> (2) But this is subject to the rule in subsection (3) which applies if, in a tax year, the settlor is—
> (a) not domiciled in the UK ...
> (3) The rule is that references in this Chapter to income arising under a settlement do not include income arising under the settlement in that tax

12 See 14.3 ("Income arising under a settlement").

year in respect of which the settlor, if the settlor were actually entitled to it, would not be chargeable to income tax by deduction or otherwise because of the settlor not being domiciled in the UK, UK resident or ordinarily UK resident.

I refer to this as the "s.624 foreign domicile defence". We must imagine that the settlor is actually entitled to the income arising under the settlement. We then ask:

(1) would the settlor be chargeable to income tax in respect of that income, and if not,

(2) would he not be so chargeable by reason of his foreign domicile?

I call this "the first counterfactual question".

14.6.1 *Meaning of "chargeable" in s.648(3)*

A UK resident foreign domiciled individual is often said to be "chargeable" to income tax on unremitted foreign income. This may even be said to be the ordinary sense of the word "chargeable".[13] I am not sure if it is right to talk of the "ordinary" sense of this protean word.[14] However, for the purposes of the s.624 foreign domicile defence it is plain

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13 Before ITTOIA this was reasonably clear because s.65 ICTA drew a distinction between a "charge" and a "computation" and 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 28.4.3 (Rates of tax on distribution income).
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.

14 The proposition that "chargeable" takes its meaning from context needs no authority; for an example, see the Special Commissioners in *Bibby v Prudential Assurance* 73 TC 235 at [34]. (Unfortunately there is no serious discussion of the word "chargeable" in the subsequent appeal to the High Court.)

that a foreign domiciled individual is not "chargeable" to tax on unremitted foreign income. This must be so since s.648(4) assumes that a UK resident but non-domiciled person may not be "chargeable" to income tax by reason of his domicile. In this context a person is only "chargeable" to income tax on an amount of income if the amount is remitted.

14.6.2 *Would the settlor be chargeable?*

In imagining that the settlor is entitled to the income, one must imagine that he is entitled to the income as it arises, that is, that he has rights in the source of the income at the time it arises. This must follow from the fact that the settlor is deemed entitled to the income: he could not be entitled to the income unless he were entitled to the source of the income.

We are now able to see how the s.624 foreign domicile defence works. Suppose:

(1) A settlor-interested discretionary trust receives foreign investment income outside the UK.

(2) The settlor is UK resident but not UK domiciled.

The answer to the first counterfactual question seems plain:

(1) The settlor would not chargeable to income tax on unremitted foreign investment income (had it been his), and

(2) the reason he is not so chargeable is his foreign domicile.

In short, foreign income qualifies in principle for the s.624 foreign domicile defence if it is received (by the trustees) outside the UK.

14.7 The s.648 clawback

Section 648 ITTOIA continues:

> (4) Subsection (5) qualifies the rule in subsection (3) if such income is remitted to the UK in circumstances such that, if the settlor were actually entitled to the income when remitted, the settlor would be

chargeable to income tax because of being UK resident.
(5) The income is treated for the purposes of this Chapter as arising under the settlement in the year in which it is remitted.

This is here called "the s.648 clawback".

Two conditions must be satisfied for the s.648 clawback to take effect:

(1) there must be "such income": i.e. income within the scope of s.648(3) (foreign income of settlement with foreign domiciled settlor); and

(2) such income must be remitted to the UK.

Then comes what I shall call "the second counterfactual question". We must imagine that the settlor is actually entitled to the income arising under the settlement when remitted. We then ask:

(1) would the settlor be chargeable to income tax on the remitted income, and if so,

(2) would he be chargeable by reason of being UK resident?

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 14.3.3 (Income of life tenant settlor).

Let us try to see how this works by examples.

14.8 Trustees remit trust income to UK

Suppose first the simplest case. A settlor ("S") has made a settlor-interested discretionary trust. S is UK resident, but not UK domiciled. 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 second counterfactual question: if S were actually entitled to that income when remitted, would he be chargeable to income tax by reason of his residence?

In principle an individual is subject to tax on remitted income if the following conditions are satisfied:

(1) The individual is entitled to the source of income when the income arises. It is suggested that a counterfactual assumption to this effect is implied by s.648(5) ITTOIA. Otherwise the s.648 clawback could never operate.

(2) The individual is UK resident when the income arises and at the time of remittance.

(3) The individual is not UK domiciled when the income arises. (If the person was UK domiciled the income would be taxed on an arising basis and the s.648 clawback would not operate.) The individual is also not UK domiciled in the year of remittance.

(4) The source of income exists in the year of remittance.

(5) The individual is entitled to the source in the year of remittance. It is suggested again that a counterfactual assumption is implied by the s.648(5) to the effect that the settlor is entitled to any source to which the trustees are entitled. Otherwise the s.648 clawback could never operate.

In short, income which is outside the scope of s.624 ITTOIA because of the foreign domicile defence *prima facie* falls back within s.624 if it is remitted.

Suppose trustees accumulate income and thus it becomes trust capital. That capital is then remitted. It is considered that the s.648 clawback applies. Its status as income or capital for trust law purposes is irrelevant; compare 9.23 (Capital/income terminology).

Suppose trustees purchase UK assets out of foreign income (land, say, or shares, or a residence, or chattels) but the income is not remitted to the UK: the purchase price is paid abroad. There is no taxable remittance. If the settlor had dealt with his foreign income in this way, he would not be subject to tax. See 9.26 (Receipt must be of money) and 9.30.3 (Purchase of UK situate asset out of foreign income).

14.9 Trustees pay income to beneficiary (not settlor)

14.9.1 *Payment to beneficiary (not settlor)*

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 his account in the UK.

Is there a s.648 clawback charge? One might say no, since the settlor is not entitled to the sum remitted. See 9.30 (Transfer of income completed abroad). However, one is bound to put the question on the counterfactual basis that the settlor is entitled to the sum! So that argument fails. It is considered that there is, nevertheless, 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. It would be surprising if there were a tax charge because:

(1) The settlor may have no way of knowing whether the income is remitted by B.

(2) The payment to a UK resident beneficiary will often involve a tax charge on that beneficiary (under ordinary principles or s.731 ITA) so there would be double taxation.

14.9.2 *Income payment to settlor-beneficiary*

Suppose:

(1) trustees pay the income to the settlor (as his income); and

(2) S remits the income.

The income is taxable as trust income. It cannot be taxed again under the s.648 clawback. The reason it is not taxed again is that it is not "such income", i.e. income arising under the settlement. It is a new source of income.

Suppose now:

(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.

By parity of reasoning it is arguable that there remains no s.648 clawback charge; but it is unlikely that the Courts will accept the argument. The better view is that in the absence of a "clean break" the sum received is to be regarded as "such income". One might regard this as an application of the principle in *Harmel v Wright*: see 9.37 (Funds returning to taxpayer).

Suppose the trustees use the income to repay an existing loan to the settlor. 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.

14.10 Deemed remittances

This section considers how the deemed remittance rules[15] apply in the context of the s.648 clawback.

Suppose:

(1) Trustees of a settlor-interested discretionary trust borrow.

(2) The debt is UK-linked (lent in the UK or lent outside and remitted).

(3) They use income to repay the borrowing (out of the UK).

There is no clawback charge under s.648(5). Although one applies the counterfactual assumption that the settlor is entitled to the income, one does not apply the further counterfactual assumption that the trustees' loan is made to the settlor.

On the other hand if:

15 See 9.39 (Deemed remittances).

(1) the settlor borrows money;

(2) the debt is UK-linked;

(3) the trust income is paid to the settlor abroad;

(4) the settlor uses the income to repay the borrowing.

It is considered that there is a clawback charge under s.648(5).

14.11 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.[16]

(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.) [17]

(4) The trustees remit income from sources which have ceased before the tax year of remittance. (Likewise the trustees may accumulate the income and pay it as capital to the settlor, who may remit it.) There is no tax charge if the source ceased to exist before the year of remittance. An example would be if the income is bank interest and the bank account was closed. The same applies if the trustees dispose

16 See 14.3.3 (Income of life tenant settlor).

17 See 9.20 (Sums received "in respect of" the foreign income). The question may arise as to whether a remittance by trustees is of income. This is decided in accordance with the principles set out in 9.24 (Tracing principle) and 9.32 (Mixed funds).

of the source of income. (That could possibly be brought about by a transfer to a company.) See 9.49.1 (When does a source cease?).

Suppose trustees of a settlor-interested trust transfer a source of income to a new trust under which the settlor still has an interest. Has the source ceased for the purposes of the source-ceasing principle? It is tentatively suggested that the answer is no. For the purposes of applying the counterfactual question under the s.648 clawback, one must assume that the settlor is entitled to all sources of income of all settlor-interested trusts. That construction is tenable on the words and would appeal to a court as it allows less scope for tax avoidance.

14.12 Critique of s.648 clawback

The clawback charge has an appearance of symmetry with the ordinary remittance basis, but the two situations are not closely comparable. 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. If trustees of a discretionary trust remit their income to the UK, the settlor is not in any way advantaged unless and until the trustees decide to transfer the income to him.

14.13 Section 624 non-residence defence to s.648

I return to s.648 ITTOIA:

> (2) But this[18] is subject to the rule in subsection (3) which applies if, in a tax year, the settlor is— ...
> (b) not UK resident, or
> (c) not ordinarily UK resident.
> (3) The rule is that 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 the settlor were actually entitled to it, would not be chargeable to income tax by deduction or otherwise because of the settlor not being domiciled in the UK, UK resident or ordinarily UK resident.

I refer to this as the s.624 non-residence defence. Where the settlor is

18 i.e. the term "income arising under a settlement".

non-resident, UK source trust income is within the scope of s.624, but foreign income is not. 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 because the settlor is not taxed on his own foreign source income, even if remitted.

14.14 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.[19]

The answer is that in these circumstances the s.648 clawback does not apply. The answer to the second counterfactual question is, no. 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.

14.15 Completion of settlor's tax return

The TSE Manual provides at 4575:

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19 See 9.18 (Income arising when non-resident, remitted when resident).

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.

14.16 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.

14.17 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 foreign domicile defences.

14.18 Income within s.624 subsequently paid to beneficiary

There is no further income tax charge when the trust income is paid to S or to any other beneficiary in the exercise of the trustees' powers over income. Section 685A ITTOIA provides:

685A Settlor-interested settlements
(1) 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 assessment or in a previous year of assessment) out of which the annual payment is made.
(2) 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).

(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.
(5) 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).
(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.

The TSE Manual 4570 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. I am unable to see the reason for this. The statutory provision only deals with discretionary trusts. But if a trust confers an interest in possession (not on the settlor) then the life tenant is not taxable if s.624 applies to tax the settlor.

14.19 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.

14.20 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 of the relevant chapters in this book. It may be helpful to summarise the major differences:

Section 624	**Section 720**
Applies if resident	Applies if *ordinarily* resident
Applies to trusts	Applies to non-resident trusts *and companies*
No motive defence	Motive defence
Settlor indemnity	No settlor indemnity

The rates of tax are slightly different, a (probably accidental) result of the FA 2006.[20] DTT relief may apply to s.624 but not s.720.

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, section 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.

20 See 28.5 (Settlor-interested trust: rates of tax on settlor).

14.21 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 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 foreign domicile defence applies) the income will not be "income arising under the settlement". The section 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.

14.22 CGT treatment of settlor-interested trust

This is discussed at 30.1 (CGT and trusts).

CHAPTER FIFTEEN

TRANSFER OF ASSETS ABROAD: INTRODUCTION

15.1 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 law published 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 cynical view that uncertainty in the scope of anti-avoidance law is desirable in itself. 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

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.

then 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.

15.2 Person abroad in EU state

Article 43 EU Treaty establishes freedom of establishment in Member States:

> 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. 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.
> Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and 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.

Article 48 extends this to companies:

> Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or 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.
> '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.

Cadbury Schweppes v IRC [2006] STC 1908 ruled:

> Articles 43 EC and 48 EC must be interpreted as precluding the inclusion in the tax base of a resident company established in a Member State of profits made by a controlled foreign company in another Member State, where those profits are subject in that State to a lower

> level of taxation than that applicable in the first State, unless such inclusion relates only to wholly artificial arrangements intended to escape the national tax normally payable. Accordingly, such a tax measure must not be applied where it is proven, on the basis of objective factors which are ascertainable by third parties, that despite the existence of tax motives that controlled company is actually established in the host Member State and carries on genuine economic activities there.

Exactly the same will apply to the TAA provisions. So the TAA provisions will not apply if the person abroad is a trust or company in a member state, and carries on genuine economic activities there. Exactly what constitutes "genuine economic activities" is at present controvertial.[2] The answer should become clearer when the *Cadbury Schweppes* litigation is complete.

15.3 "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,

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2 For HMRC views see "Taxation of the foreign profits of companies: a discussion document" (June 2007) accessible *www.hm-treasury.gov.uk/media/531/A6/consult_foreign_profits220607.pdf.*
"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.

(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. It must be stressed that 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.

15.4 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".

15.5 Person abroad

Section 718(1) ITA provides:

> In this Chapter "person abroad" means a person who is resident or domiciled outside the UK.

15.5.1 *Foreign incorporated company*

Section 718(2) ITA provides:

> For the purposes of this Chapter, the following persons are treated as resident outside the United Kingdom—
> (a) a UK resident body corporate that is incorporated outside the UK.

This is otiose because even in the absence of this provision a foreign incorporated company would be "domiciled" outside the UK[3] and so regarded as a person abroad.

This rule made sense before the introduction of corporation tax in 1965; until then, foreign incorporated companies were taxed on the remittance basis. Now it is inappropriate because a UK resident company pays tax on its profits on an arising basis.

One situation in which this 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. Another 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.[4] If it were desired to discourage this type of planning, the TAA provisions are not the sensible way to go about it. It is suggested that this rule should be abolished.

15.5.2 *Trustees and PRs*

Section 718(2) ITA provides:

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3 See 3.16 (Domicile of company).

4 See 18.2 (Double taxation issues); 18.38 (Motive defence issues).

> 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.

15.6 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.[5]

In *Latilla v IRC*[6] 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 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.

15.6.1 *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-

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5 *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.

6 25 TC 107. I mention for completeness only that this was followed in *Brackett v Chater* 60 TC 143.

resident or foreign domiciled transferor would never be a relevant transfer, which is certainly not the case.

15.7 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.

15.8 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.)[7]

15.8.1 *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 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;[8]

(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

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7 See 45.2.3 (Broad definition of "settlement").

8 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.

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.[9]

15.8.2 *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 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?[10]

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.[11] (An independent reason is that (maybe) no income becomes payable, as discussed above.)

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9 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.

10 [1998] BTR 392.

11 Of course in practice considerations of materiality might also arise.

15.8.3 *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.

15.8.4 *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.

15.8.5 *Transfer for issue of bond or life insurance policy*

The same applies if T subscribes for a bond or life insurance policy from 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.

15.8.6 *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.[12]

Example [1] is the person who invests[13] in an offshore bank account. That person makes a transfer of assets to a person abroad (the bank). It may be true that the income from such investments (i.e. bank interest) "remains liable to tax in the usual way".[14] But while this explains why HMRC would not wish to apply s.720 ITA, it does not actually offer any defence to the provisions. (This fact is relevant to the motive defence, but it would be surprising if the only defence to s.720 was the motive defence.)[15] 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 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.

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12 EN to section 79, para. 63.

13 A lawyer would call this a "deposit of funds" not an "investment" but nothing turns on that.

14 It is not 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.

15 No-one expects the depositor to claim the motive defence in his tax return.

15.9 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.

15.9.1 *Purchase of funded company directly*

Suppose T (UK resident) buys the shares of an already existing non-resident company ("a funded company"). Assume the company owns assets. That purchase involves a transfer of assets by T—the payment of the purchase price[16]—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 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 funded 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 funded company's income.[17] 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).

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16 The sale in fact involves two transfers of assets: payment of the purchase price to the vendor and transfer of the shares to T.

17 As to whether T is the transferor, see 16.3 (Who is the transferor?).

The funded company may later make a relevant transfer.[18] If T procures that transfer, he is its transferor.

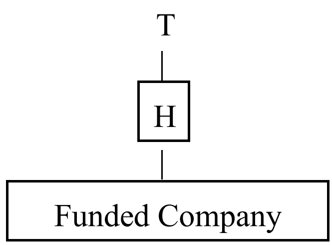
15.9.2 *Purchase of funded company by holding company*

Now suppose:

(1) T transfers assets to H, an offshore company (“the H transfer”).

(2) H uses its funds to purchase a funded 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 arises to a person abroad as a result of that transfer.[19]

(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 funded company, but not as a result of the H transfer or the purchase price transfer. However, if H provides further funds for the funded company, directly or indirectly, then the funded company will receive income as a result of the H transfer and T will be subject to tax under s.720 accordingly.

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18 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 15.8.1 (Purchase of asset from person abroad).

19 Assume no income accrues to H (the funded company does not pay a dividend).

15.10 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[20] any of the assets transferred,
> (c) the income arising from any assets within paragraph (a) or (b), or
> (d) any assets directly or indirectly representing the accumulations of income arising from any assets within paragraph (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 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.

15.10.1 *"Operation"*

"Operation" is (rightly) not defined but is clearly a word of wide import.

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20 "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.

It includes a company becoming non-resident.[21] It does not include death, but that does not matter because it does include the act of making a will.[22]

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".

15.10.2 *"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.

In *Carvill v IRC*[23]:

(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.

21 *Congreve v IRC* 30 TC 163.

22 *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".

23 [2000] STC (SCD) 143 para 80-85.

(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.

15.10.3 *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.[24] 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.

15.10.4 *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

(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:

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24 "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.

(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.

15.11 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"[25] 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 of transfer and/or associated operations.[26]

(2) Section 721 ITA: Individual has "power to enjoy" as a result of

25 See 15.3 (Relevant transfer).
26 See 15.12 (Person abroad receives income indirectly).

transfer and/or associated operations.[27]

(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.[28]

(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.[29]

(6) *Motive defence*: All the relevant transactions must satisfy the conditions of the motive defence.[30]

15.12 Person abroad receives income as indirect consequence of transfer

15.12.1 *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:

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27 See 15.9 (Power to enjoy: causation condition); also power to enjoy, Condition C.

28 See 17.6 (Benefit received: causation condition).

29 See 17.26 (Is income of company relevant income?).

30 See 19.39 and 19.40 (Motive defence before/after 5 December 2005).

> 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.

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:[31] 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?

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:[32]

> One might reach this result by understanding [restricting] the reference

31 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 19.39 (Associated operations and the motive defence).

32 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?

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.[33] I infer that HMRC found causation an inconvenience, so they quietly[34] but very 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 clearly a transferor, A is not to be regarded as transferor. This has some

33 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.

34 The EN did not mention this important change.

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.[35] 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?[36] If not, the operations are not associated.

15.12.2 *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

35 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.

36 See 45.4 (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.[37]

15.12.3 *Transfer to trust followed by transfer from trust to offshore company*

This is in principle the same as 15.12.2 (Transfer from A to UK trust followed by appointment of offshore trustees). 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.

15.12.4 *Transfer to company followed by migration of company*

This is a relevant transfer even without the associated operations rules.[38]

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37 The position in 15.12.1 (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 15.6 (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.

38 See above footnote.

15.12.5 *Transfer to UK trust followed by migration of trust from 6 April 2006*

Suppose the facts of 15.12.2 (Transfer to UK trust followed by migration), 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 15.12.4 (Transfer to company followed by migration of company). The end result is the same, though the route to that destination is different.

15.13 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.

15.14 Capital receipts deemed to be income

The transfer of asset rules refer to "income". This means "income for income tax purposes" which is a different concept from "income for trust law purposes" or "income for accountancy law purposes".[39]

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[40] 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 22.9 (Gains accruing to non-resident trusts). On gains from life policies see 21.4.1 (Non-resident trusts) and 21.4.2 (Non-resident company).

15.15 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.

15.15.1 *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.[41]

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 purposes (except section 397(1)).

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39 See 8.2 (Why does "capital v income" matter?)

40 This is assumed to be the case in the drafting of s.686A(4)(b) ICTA.

41 References in this section to dividends also include other company distributions.

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. Section 743(2) ICTA provides that:
>
> > 'In computing the liability to income tax of an individual chargeable by virtue of section 739 ICTA, the same deductions and reliefs shall be allowed as would have been allowed if the income deemed to be his by virtue of that section had actually been received by him.'
>
> It follows 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.[42]

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.

15.15.2 *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

42 *Carvill v IRC* [2000] STC (SCD) 143.

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 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.

15.15.3 *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.

15.15.4 *Property income of person abroad*

The rules for measuring property income are the same as for the settlement provisions; see 14.3.4 (Property income). Transfer pricing may also need consideration here.

15.15.5 *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.

15.16 Disclosure of TAA issues in tax return[43]

Question 6 of the 2004/05 self assessment return provides:

> Have you or could you have received, or enjoyed directly or indirectly, or benefited in any way from, income of a foreign entity as a result of a transfer of assets made in this or earlier years?

This wording has been used since 1999, probably as a result of John Avery Jones' harsh criticism of the earlier wording.[44] 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, or enjoyed directly or indirectly, or benefited in any way from, income of a foreign entity as a result of a transfer of assets made in this or earlier years *in circumstances in which s.720 or s.731 apply to you*?

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43 See also 19.44 (Motive defence claim in tax return).

44 "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 often arise now.

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 transferor or (2) he has received benefits.

CHAPTER SIXTEEN

TRANSFER OF ASSETS ABROAD: SECTION 720

16.1 The charge to tax

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 28.6 (Rates of tax on transferor).

16.2 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:

> **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". The reference to "such an individual" refers back to s.720(1). 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". 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 p`erson 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. [Section 721 ITA] and section 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 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.

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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* where Spooner says:

> "... 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*."

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.

16.3 Who is the transferor?

The question which then arises is to identify the individual transferor (if there is one). Clearly, anyone who actually makes a transfer is a transferor, but the expression is a little wider than this. We now need to consider exactly how much wider.

16.3.1 *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.739 ICTA 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.

16.3.2 *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 non-resident 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:

> 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

2 30 TC 163 at p.197.

3 54 TC 503 at 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.

6 p.601B.

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.

An easy example is if T transfers assets to a company in consideration for which the company issues shares to a person abroad.

Another 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.

In *Carvill v IRC*, T transferred the majority shareholding to a person abroad, and the minority shareholders transferred their shares. HMRC argued that T was the "transferor" of the minority shareholding! But this

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7 57 TC 1 at p.51 B –D and p.55 E–F.

8 *IRC v Pratt* 57 TC 1 at p.50.

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. Mr Vallance 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 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. So the concept of "procuring" a transfer only applies to individuals controlling companies or trusts.

16.3.3 *HMRC Practice*

HMRC say in RI 201:

9 *Carvill v IRC* [2000] STC (SCD) 1543 paras.71-72.

[1] Section 739 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 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]

16.4 Must the transferor have avoided income tax?

In *McGuckian v IRC* 69 TC 1 it was argued from s.720(1) ITA that s.720 only applied if (in the absence of the section) income tax would be avoided. The argument was politely but firmly rejected: see pp.77E, 82.

16.5 Must the transferor have had the purpose of avoiding income tax?

The reference to "such an individual" in s.720(2) ITA might further refer only to an individual who has had the purpose of avoiding income tax by

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10 The passage is set out at 16.3.2 (Transfer procured by individual).

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.

means of a transfer of assets. Before 1997 it was therefore arguably a requirement of s.720 that the purpose, or one of the purposes, of the transfer (or of the transferor) had to be the purpose of avoiding income tax. This point was never decided.[12] But now s.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 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, discussed at 19.1 (Motive defence).

16.6 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.

16.6.1 *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.[13]

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.[14] (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

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12 The arguments are set out in *Botnar v IRC* [1998] STC 38 at p.63ff.

13 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.

14 Of course, CGT, VAT, IHT, and SDLT all need consideration.

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.[15]

16.6.2 *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.[16] This was eventually upheld in *IRC v Willoughby*[17] reversing *Herdman v IRC* 45 TC 394.

The position now is governed by s.720(5):

> 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.[18]

16.7 Power to enjoy: Condition A

Section 721 provides:

> **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

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15 See 9.18 (Income arising when non-resident, remitted when resident).

16 "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*.

17 70 TC 57.

18 Also see 17.3.1 (Transferor not ordinarily resident: pre-1996 income).

> 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.

Once one has identified the transferor one asks whether he has "power to enjoy" any 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 short, 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 IT purposes,[19] though for most practical purposes they are the same. It is hard to see the reason for the distinction, but there it is.

On a transfer from a UK domiciled person to his foreign domiciled spouse, see 41.17 (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.

Section 722 states that an individual is *treated* as having power to enjoy if any of the five conditions are 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.

19 See 14.4 ("Settlor-interested").

16.7.1 *Condition A: income in fact dealt with to benefit T*

Section 723(1) provides:

> 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 unlawyer like language was discussed by the Special Commissioners in *Botnar v IRC*:

> 222. [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.[20]

16.7.2 *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.

20 72 TC 205. The wording is also discussed *obiter* in *Vestey v IRC* 54 TC 503 at 555.

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 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 have reached 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 condition 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).[21] 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.[22] 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.

16.7.3 *Condition C: individual receives benefit*[23]

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.

21 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.

22 *IRC v Brackett* is another example.

23 See "Section 739 and benefits in kind", Robert Venables QC, OTPR Vol 11 Issue 3 p.1.

> (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).

This again 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 the 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, but this was before s.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* on Condition C. 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 debt) is nil, Condition C is not now satisfied.

The ITA no longer contains the definition of benefit, so the position is now clear.

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.

16.7.4 *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 the individual had no power to enjoy within D because what he could receive was capital and so no longer "income".[24]

(2) The trust held a company. Walton J held that the individual had no power to enjoy the company's income within D because what he could receive was dividends from the company and that was not the same as the "income" of the company.[25]

24 *Vestey v IRC* 54 TC 503 at 555.
25 *Vestey v IRC* 54 TC 503 at 562-3.

This is bizarre and in the House of Lords Viscount Dilhorne rejected it.[26] It is considered that Dilhorne's reasoning is to be preferred.

16.7.5 *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.[27]

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 [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, 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

26 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.

27 *IRC v Schroder* 57 TC 94 at 125, followed in the non-tax case *R v Radio Authority ex p. Guardian Media Group* [1995] 1 WLR 334 at 345.

> 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 Condition E is satisfied and none of the other four 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 Condition E. But T would also probably satisfy Condition B as company income would tend to increase the value of the voting shares (voting shares do have some value).

16.7.6 *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 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.[28]

16.8 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.[29] It seems at first sight that condition A is satisfied and A is taxable under s.720 on the income of B's trust! This clearly cannot be right, but why not? This raises questions similar to those discussed in paragraph 15.12.1 (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.

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28 See R S Boyd, "Requiem for a Man of Straw" [1980] BTR 442 at p.457.
29 See 15.10 (Associated operations).

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).

16.9 The income to be charged[30]

16.9.1 *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[31] or even none[32] of the income. In such a case T is taxed on all the income: *Howard de Walden v IRC.*

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.[33]

16.9.2 *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:

(a) income from the assets transferred by T;

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30 See R.S. Boyd "Requiem for a Man of Straw" [1980] BTR 442; see 16.9.2 (Person abroad with independent source of income).

31 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 Condition B.

32 e.g. if T has control within Condition E

33 *Congreve* 30 TC 163 at p.199.

(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.

We must once again return to sections 721 ITA:

> (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.

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".[34] 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.

34 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.

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.

16.10 Income chargeable: 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 United Kingdom.

I find it difficult to think of any income which would not be chargeable if received by a UK ordinarily resident individual, and this condition will in practice always be satisfied.

16.11 Capital receipts and the measure of income within s.720

See 15.14 (Capital receipts) and 15.15 (Amount of income of person abroad).

16.12 Transferor receives capital sum

Sections 727 and 728 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).

(2) Section 725 (reduction in amount charged where controlled foreign company involved) applies for determining the amount of income treated as arising under subsection (1) as it applies for determining the amount so treated under section 721(1).

(3) It does not matter for the purposes of this section—

(a) whether the income would be chargeable to income tax apart from section 727,

(b) whether the individual is ordinarily UK resident at the time when the relevant transfer abroad is made, or

(c) whether the avoiding of liability to income tax is a purpose for which that transfer is effected.

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.

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 making an (arm's length) loan to a settlor 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).

16.12.1 *Relationship of s.720 and s.727*

In *Vestey v IRC*, Walton J said:

> These subsections 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.[35]

16.13 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.

16.13.1 *"Receives"*

"Receives or is entitled to receive" is glossed in s.729(4) ITA:

> 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.

16.13.2 *"A capital sum"*

"Capital sum" is defined in s.729(3) ITA:

35 54 TC 503 at 556.

> In subsection (1) "capital sum" means—
> (a) any sum paid or payable by way of loan[36] 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 para.266 the Special Commissioners say:

> In our judgment the entitlement to use the flat is not a capital sum within the definition in s.739(4); in particular we hold that the entitlement to use was not a "sum" within any normal use of English.

16.13.3 *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.

16.13.4 *"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").

(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

36 "Loan" is a fairly narrow term and does not include a purchase price left unpaid: *Ramsden v IRC* 24 TC 515.

comparable concept "in relation to"). "Connected with" is of course a concept used in other anti-avoidance provisions.[37]

16.13.5 *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*,][38] 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 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

37 See *Emery v IRC* 54 TC 607.

38 But these words are wrong since s.739 is limited to transferors.

> 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.[39]

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 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.

39 54 TC at 594.

(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.[40] 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.

16.14 Section 720 foreign domicile defence

Section 726 ITA provides:

> **Non-domiciled individuals**
> (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.
> (2) Condition A is that the individual is domiciled outside the UK.
> (3) Condition B is that if the income had in fact been the individual's

40 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.

income, because of being so domiciled the individual would not have been chargeable to income tax in respect of it.

This is based on the wording of the settlement provisions. The discussion on the settlement provisions is applicable here.[41] In short, where the transferor is UK resident but not UK domiciled, foreign income received by the person abroad is in the first instance outside s.720. Section 726 is needed because s.720 income is not relevant foreign income, and so does not qualify for the RFI remittance basis.

Is there a 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)?

It is considered that income subsequently received in the UK is tax free. Section 726 has no equivalent of the s.648 clawback.[42] The whole purpose of the clawback is to deal with this situation. Michael Flesch QC agrees:

> When considering the section 739 ICTA liability of a foreign domiciliary in respect of non-UK source income one must test the position either at the time of actual receipt of the income in question by the non-resident entity or, at latest, at the end of the year of assessment in which the income arises to the non-resident entity. There is in my view nothing in section 739 itself, or in section 743(3), that tells us that a subsequent remittance of that income can affect the situation.[43]

At first sight it seems an attractive argument that the Court should apply a purposive construction and hold that s.726 imposes a charge in these circumstances. It is not easy to construe the wording to have this effect. It would follow that s.648 clawback is otiose but this is not a fatal objection. The fundamental and unanswerable objection is that this

41 See 14.6 (s.624 foreign domicile defence).

42 See 14.7 (The s.648 clawback). There may in some cases be a charge under the s.648 clawback in these circumstances.

43 *GITC Review* Vol 1 Issue 2 p.13 accessible *www.taxbar.com*.

purposive argument wrongly assumes that the purpose of Parliament is to impose a charge on a remittance by the person abroad who receives the foreign income.[44] But on reflection that is a pretty daft state of affairs, for the reasons given in 14.12 (Critique of s.648 clawback).

On the application of the foreign domicile defence to trading income, see 11.2 (To whom does trading income arise?).

16.14.1 *Tax planning for foreign income within section 720 foreign domicile defence*

If the view expressed above is right, foreign income may subsequently be remitted without a charge under s.720 (though many other provisions need to be considered). But even if that view is wrong then the usual principles of the remittance basis apply, so:

(1) Capital may be remitted.

(2) A foreign domiciliary may use income within s.720 abroad.

(3) He may use the income to make a gift completed abroad. The donee may remit the income. However, a gift to a spouse or civil partner would arguably not count for this purpose: see s.714(4) ITA.

(4) Income from a source which has ceased to exist may be remitted.

16.15 No indemnity for transferor

The transferor has no express statutory indemnity against the person abroad for tax paid under s.720. It is suggested that no indemnity can be implied.

16.16 Section 624 ITTOIA *v.* 720 or s.727 ITA: comparison and priority

See 14.20 (Section 624 *v.* 720).

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44 "Quite often the benefits of a 'purposive' approach are illusory, since the purpose which is used as a point of reference reflects the contention of one or other of the parties about what the words ought to mean": *Chan Chi-hung v The Queen* [1996] AC 442 at 452.

CHAPTER SEVENTEEN

TRANSFER OF ASSETS ABROAD: SECTION 731

17.1 Introduction

Section 732 ITA provides:

732 Non-transferors receiving a benefit as a result of relevant transactions
(1) This section applies if—
(a) a relevant transfer[1] 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) 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, and
(e) the individual is not liable to income tax on the amount or value of the benefit (apart from section 731).

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".

The consequences where all these conditions are satisfied are set out in s.732(2):

1 See 15.3 (Relevant transfer).

Income is treated as arising to the individual for income tax purposes for any tax year for which section 733 provides that income arises.

Section 731 then 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. ...

17.2 Ordinary residence at time benefit received

Section 731 only applies if the individual is ordinarily UK resident at the time he receives the benefit. If he receives a benefit but is not ordinarily resident at that time there is no charge under s.731 in relation to that benefit.

Suppose:

(1) Year 1: B is ordinarily resident in the UK. "Relevant income" arises (see 17.9 (Relevant income: definition)) but B receives no benefit, so there is no s.731 charge.

(2) Year 2: B is not ordinarily resident in the UK, but he receives a benefit.

There is no charge under s.731 in relation to this benefit, and this remains the case even if B later becomes UK resident again.

Now reverse the facts:

(1) Year 1: B is not ordinarily resident in the UK and "relevant income" arises.

(2) Year 2: B is ordinarily resident in the UK and receives a benefit.

There is in principle[2] a charge under s.731.

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.

The benefit is in principle treated as income of B in year 2. It is arguable that this deemed income is not subject to tax by virtue of the implied territorial limitation of UK taxation; see 8.4 (Situs of source). The position is however unclear .

17.3 Transferor's s.731 defence

Section 731 only 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 ...

See s.732(1)(d) ITA. I refer to this as the transferor's s.731 defence.

Section 732(1)(d)[ii] makes clear (what was formerly implied) that a non-UK domiciled transferor who is outside the charge to tax under s.720 by virtue of the 720 foreign domicile defence[3] is not assessed under s.731. 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.

17.3.1 *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

2 Assume that the s.731 foreign domicile defence does not apply.

3 See 16.14 (s.720 foreign domicile defence).

until 1996.[4]

RI 201 provides:

> Similarly, a transferor of assets who is outside the charge to tax under Section 739 ICTA 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.

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.

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[5] 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.

17.3.2 *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. For instance, if:

(1) T is ordinarily resident when he makes the transfer;

(2) T is non-resident for a period ("the non-resident period");

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4 See 16.6.2 (Transferor not ordinarily resident when transfer made).

5 I need not now consider the position if the benefit was received before 26 November 1996 but the result was probably the same.

(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.

17.3.3 *Spouse/civil partner 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".[6]

17.4 "Benefit"[7]

The word "benefit" is used for two main purposes in the transfer of asset provisions:

(1) Section 731 applies if the individual receives a "benefit" and the charge is by reference to the amount or value of that benefit.

(2) The word "benefit" is used three times in the definition of "power to enjoy" which is relevant to s.720.

It is well established that "benefit" is a word of wide import. There are no express valuation provisions,[8] so the value of a benefit means market

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6 See 1.2 (Meaning of spouse) and 1.3 (Meaning of civil partner).

7 The word "benefit" is used in many areas of law. The discussion in Venables, *Non-Resident Trusts*, 8th ed., on the meaning of "benefit" for the purposes of s.87 TCGA is relevant here; likewise *Drafting Trusts and Will Trusts*, James Kessler QC, 8th ed., para. 13.12 (Settlor exclusion clause).

8 Contrast the elaborate valuation rules for employee benefits; this is another manifestation of the patchwork nature of IT.

value.

The pre-ITTOIA legislation stated that "benefit" included a payment of any kind.[9] This had no practical effect, and it has sensibly been omitted from the present legislation.

17.4.1 *Arm's length bargains*

A bargain for which the individual gives full consideration (e.g. a sale to or from a trust or company within section 731) is not a "benefit".[10]

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.[11]

17.4.2 *Receipt or sale of equitable interest*

RI 201 states:

> For the purposes of Section 740(1)(b) ICTA a benefit is treated as not including
> [1] either the giving[12] 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 revocable (or else the value of the benefit is nil).[13] If the interest is not revocable, then its receipt is a benefit, but this is still outside the scope of

9 Section 742(9)(c) ICTA.

10 This is self-evident; but if authority is needed, see *IRC v Lactagol* 35 TC 230 and *Wilson v Clayton* [2005] STC 157.

11 *Wilson v Clayton* [2005] STC 157 decided that this is not a benefit for the purposes of employment-related benefits. Note the reference to arm's length transactions in the passage from *Cooper* cited at 17.4.8 (Benefit under terms of trust); the same should apply for s.731.

12 "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.

13 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.

s.731 because such a benefit is not "provided out" of trust assets, 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.[14] 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.[15]

17.4.3 *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[16] and so if the trustees appoint the proceeds to B, he receives a benefit taxable under s.731.

17.4.4 *Interest-free loan and enjoyment of asset in kind*

RI 201 continues:

> 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. 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.

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14 The drafter of FA 1984 Sch 14 para. 5(4) reached the same conclusion for the purpose of (what is now) s.87 TCGA.

15 On a sale of an equitable interest, watch:
(1) CGT on the disposal of the interest; and
(2) TCGA Schedule 4A.
On the planning possibilities, see 17.38.2 (Sale of equitable interest scheme).

16 See 17.23 (Tracing relevant income).

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 p.81–85.

17.4.5 *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,[17] 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.

17.4.6 *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.

17.4.7 *Interest bearing loan to life tenant*

It is impossible to have an interest bearing loan to a life tenant, under a

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17 See 8.16 (Situs of source of interest).

transparent *Baker* type[18] 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[19] or purportedly rolled up.[20] 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.

17.4.8 *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 the CGT offshore beneficiary provisions: see section 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"[21] and the value of the "benefit" is

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18 It would be different if the trust was a non-transparent *Garland* type trust. See 8.18 (Income from IP type trusts).

19 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.

20 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).

21 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 to consider what was the value of the benefit.

equal to the value of the trust property. The concepts of "value" and "benefit" can (just) be stretched wide enough to support this conclusion[22] and any other view would be inconsistent with the scheme of the provisions. This view is supported by *Cooper v Billingham* 74 TC 139 para 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[23] 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.[24]

17.4.9 *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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22 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. This view also gains (slender) support from the definition of "benefit" but it is not necessary to rely on that.

23 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.

24 This was stated (obiter) by the judge in *Cooper v Billingham* 74 TC 139 at p.155.

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.

17.4.10 *Reimbursement of tax under statutory indemnity*

HMRC accept that the reimbursement of tax under a statutory indemnity such as s.646 ITTOIA or paragraph 6 Sch. 5 TCGA is not a benefit: see SP 5/92 para.8.[25] HMRC have suggested that this does not apply if the reimbursement is made before the settlor has paid the tax for which he seeks 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.

17.4.11 *Benefit of use of asset owned jointly by individual and person abroad*

On this topic see 38.21 (Co-ownership defence).

17.4.12 *Benefit from trust/company under Court Order in divorce proceedings*

It is important to understand the family law background. The CG Manual 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.

This is not correct.[26] After considering the exceptional case where there

25 In practice this is more of an issue for CGT than for s.731.

26 See *Hill v. Haines* [2007] EWHC 1012.

is gratuitous intent, which is not relevant here, the Manual continues:

> 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*[27] 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.

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?

If an inter-spouse transfer is not under a court order, HMRC take the view that the transfer is made for actual consideration. If that were correct then a transfer from a trust to W (in the context of a divorce) would not be a benefit to W (who gives consideration) but it would be a benefit to H. But since the correct view is that inter-spouse transfers are not made for consideration, this analysis rests on false foundations.

If the transfer is under a court order, including a consent order or *Tomlin*

27 *G v G* [2002] EWHC 1339 [2003] Fam Law 14 [2002] 2 FLR 1143 at para [43] accessible *www.kessler.co.uk* approved in *Hill v Haines* [2007] EWHC 1012.

order, HMRC rightly 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.[28] 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.

17.5 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.

For the purposes of s.87 TCGA charge, the concept of "receipt" is explained by s.97(5) TCGA.[29] There is no statutory equivalent here but it is suggested that the same rules apply: s.97(5) is merely an explanation of 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,

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28 There is a power to vary nuptial settlements, but I assume that power is not exercised.

29 "For the purposes of sections 86A to 90 ... 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."

non-financial advantage.[30] That is not a "benefit" for the purposes of s.731. Where the parent is under a direct 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.[31]

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, it is not one which is provided "in consequence of the transfer or any associated operations".

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 foreign domicile defence). The documentation in these circumstances is very important.

17.6 Benefit causation conditions

Not every benefit that an individual receives falls within s.731. Section 732(1)(c) ITA requires:

> 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

30 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.

31 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*, James Kessler QC, 8th ed., para. 13.12 (What does a settlor exclusion cause cover?).

(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.

17.6.1 *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 foreign domicile defence.[32] 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) gives the asset to another beneficiary[33] ("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

32 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.

33 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).

another.[34] 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.[35] It is suggested that the principles to apply are those of the clean break test.[36]

Consider a trust where the settlor is a beneficiary and the settlor wishes to make a payment to another beneficiary, not the settlor. A direct payment from the trustees to that beneficiary may be within the scope of s.731. In that case the solution may be to make regular payments to the settlor who may subsequently make a gift to the beneficiary, but this can only succeed if the gift is genuinely independent, which may not be easy to arrange.

17.7 Benefit liable to IT defence

Section 731 only applies if:

> the individual is not liable[37] to income tax on the amount or value of the benefit (apart from section 731).

See s.732(1)(e) ITA. I refer to this as the "benefit liable to IT defence".

Unremitted foreign income of a UK resident foreign domiciled individual is "liable" to income tax for this purpose.[38] This question arises in a variety of situations where an individual receives foreign income and the s.731 foreign domicile defence does not apply.

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34 Assume there is sufficient relevant income.

35 The argument would be the same as in 15.12 (Person abroad receives income indirectly).

36 See 45.4 (Gift from A to B followed by gift to trust by B).

37 The word in the pre-ITA legislation was "chargeable" not "liable" but the change has not altered (and has perhaps clarified) the position.

38 This might not seem to accord with the natural meaning of "liable"; but it is consistent with the well established rule that a pension scheme and a charity within the charity exemption is "liable" to tax for the purposes of DTTs; see James Kessler, *Taxation of Charities*, 5th ed., Key Haven, para. 13.2. (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.

17.7.1 *Unremitted income and non-excluded relevant income*

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?[39] 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 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.[40] Anti-avoidance provisions, like hypotheses, should not be multiplied unnecessarily.

The same issue arises where B receives income *in specie* in the form of chattels, which are received in or brought to the UK. There is no tax

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39 The s.731 foreign domicile defence is not in point because the trustees have received UK source relevant income: see 17.33 (Section 731 foreign domicile defence).

40 See 17.3 (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 18.6 (Double counting relief). But there is no provision allowing tax paid under s.731 to be reclaimed.

charge under the RFI remittance basis until the chattels are sold.[41] B is nevertheless liable to IT on the benefit so s.731 does not apply.

17.7.2 *Income benefit remitted without remittance basis charge*

The same issue arises where:

(1) a discretionary trust within s.731 receives only foreign source income;

(2) B receives income (unremitted foreign trust income) from the trust.

B is not subject to tax on the unremitted foreign trust income because the income is unremitted. B is not subject to tax under s.731 because of (i) the benefit liable to IT defence and (ii) the s.731 foreign domicile defence. At this stage it does not matter which defence applies. Suppose however:

(3) the trust comes to an end and the trust income is remitted in a subsequent tax year.

There is still no charge under the RFI remittance basis because the source ceasing rule applies. The benefit is now received in the UK so the s.731 foreign domicile defence ceases to apply.[42] Could there be a charge under s.731? It is considered that the answer is no, because the question whether B is liable to IT on the benefit is arguably to be decided in year 1, the year it was received. In that year T was liable.[43]

17.8 Charge limited to lower of value of benefit and "relevant income"

Section 733 ITA provides:

> **Income charged under section 731**
> (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*

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41 See 9.28.1 (Dividend of chattel in specie).
42 See 17.35 (Receipt of asset outside UK and subsequent remittance).
43 See 28.4.3 (Rates of tax on distribution income).

Identify the amount or value of such benefits received by the individual in the tax year and in any earlier tax years in which section 732 has applied.

The sum of those amounts and values is "the total benefits".

Step 2

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".

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".

Step 5

Deduct from total relevant income—

(a) the amount deducted at Step 2, 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".

Step 6

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.

In short, 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.

Contrast s.720, which imposes a charge on the whole of the income accruing to the person abroad.

17.9 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 provisions; see 15.6 (Income becomes payable to person abroad).

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, for ease of exposition, I do 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" discussed at 7.5 (RFI).

17.10 Capital receipts deemed to be income, policies and offshore funds

See:

(1) 15.14 (Capital receipts deemed to be income).

(2) 21.4.2 (Non-resident company).

(3) 22.9 (OIG accruing to non-resident trust).

17.11 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;[44] here the distinction between the actual stock dividend and the fictional income is similar but clearer.[45]

17.12 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; see 17.18 (Income of discretionary trust distributed to beneficiary in year it arises).[46]

There is nothing surprising in this conclusion: there is no need for s.731

44 See 32.4 (Distinction between income and sum equivalent to income).

45 The same point arises for AIS income; see 23.11.1 (s.731 ITA).

46 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 17.15 (Income which "can" be used to benefit another person).

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 as he receives it, and on other benefits (if he receives any) to the value of the relevant income.

17.13 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.

17.13.1 *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:

> 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 does not actually pay tax due on the income.

17.13.2 *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 foreign domicile defence does not apply).[47]

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 within that defence: see 14.6 (s.624 foreign domicile defence). 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:

(1) Year 1: a beneficiary ("B") receives a benefit but does not pay tax as there is no "relevant income".

(2) Year 2: foreign source income arises on which the settlor ("S") is not subject to tax as the foreign domicile exemption for s.624 applies. This is relevant income in relation to B, so B pays tax under s.731.

(3) Year 3: that income is remitted to the UK, so S pays tax under s.624.

Where s.720 applies (as well as s.624) see 17.14.

17.13.3 *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.

47 See 14.6 (s.624 foreign domicile defence).

Section 624 does not apply to foreign source trust income: see 14.13 (Non-residence defence to s.648). 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".

17.14 Is income within s.720 "relevant income"?

The position is less clear if income falls within s.720 and not s.624. HMRC say in RI 201:

> Where a non-UK domiciled individual transfers assets but is not chargeable to tax under the provisions of s.739 ICTA owing to s.743(3) ICTA, there is no bar in the Revenue's view on the application of s.740 ICTA to others who did not themselves make the transfer but were beneficiaries of it.

ITA EN confirms that the same view holds for the current law:

> Where a non-UK domiciled individual transfers assets but is not chargeable to tax under section 739 owing to section 743(3), there is no bar in HMRC's view on the application of section 740 to others who did not themselves make the transfer but were beneficiaries of it. HMRC interpret clause 732 in the same way.[48]

In HMRC's view the position is the same as in the s.624 case:

(1) income taxed on the transferor under s.720 is not "relevant income"; but

(2) income within the s.720 foreign domicile defence is "relevant income".

However, there are differences between s.624 and s.720. Section 720

48 See Change 105 in EN Vol III, annex 1.

provides that income is treated as arising to an individual but does not deem the income of the person abroad to be the income of the individual. So it appears that the income of the person abroad does not cease to be income of the person abroad, so it is also relevant income. The only defence is s.743 ITA (double counting relief).[49] 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.

In the 5th edition of this book, I consider the argument that income within the old s.739 foreign domicile defence could still not be relevant income. The argument does not run (or at least, is made much weaker) under the ITA provisions. It is fairly clear that income arising from 2006/07 is relevant income even if it falls within the s.720 foreign domicile defence.

17.15 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.[50]

One might refer to this as "can contingently".

17.15.1 *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

49 See 18.6 (Double counting relief).

50 *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.

contingency plainly must be ignored or the definition does not work.[51]

17.15.2 *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 17.26 (Is income of a company held by trust "relevant income"?).

17.15.3 *Income of A&M trust only payable to B on remote contingency*

Now consider this type of Accumulation and Maintenance trust,[52] divided

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51 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 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).

52 This was quite a common form before the abolition of relief for A&M trusts in 2006.

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:

(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*.[53] 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)

53 See Christopher Williams, *op. cit.* p.139; *may* (compared to *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.

would not be just or fair.[54]

17.15.4 *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 a more limited class, and it is arguable that trust income is not relevant income in relation to other potential beneficiaries.

17.16 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 does not benefit); or

(c) retained by the trustees, but on terms under which B cannot

54 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.

benefit.

(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 not born until later;

   (b) if one share of a trust fund later accrues to another share (e.g. on the death of a beneficiary);[55] or

   (c) 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.

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.

An important consequence of all solutions except (1) is that trustees of an offshore 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.

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55 See 17.15.3 (Income only payable to B on remote contingency).

Then the income will not be relevant income of 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.

17.16.1 *The legislation*

We must return to s.733 ITA Steps (3) and (4):

> *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".

The legislation 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* in relation to year 2 and so the s.731 charge arises in year 2 and not in year 1. However, the reference in the statute is to income of the tax year *in relation to the tax year*. This suggests 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. 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 [earlier] 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 italics are the words of Step 3; the words underlined are added; note that some words must be added in any event.)

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.[56]

So the author considers 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:

56 I have considered whether any guidance is to be found in the principle that income tax is an annual tax: see 9.49 (Source-ceasing). However, that does not shed much light on the problem.

> 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.[57]

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 an accounting period or year of assessment.[58] In other cases it is only possible to ascertain a moment at which income arises by rules of a somewhat arbitrary kind.[59]

17.17 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) a published exchange of correspondence:

> **CIOT Letter**
>
> ...
>
> 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 Part XV ICTA or under paragraph 6 of Schedule 5 to TCGA, such a payment would not be regarded as:
>
> (a) A capital payment for section 87 TCGA purposes;
>
> (b) Taken into account for section 740(1) ICTA purposes;
>
> (c) Income of the settlor for Case V Schedule D purposes.

---

57 ITA EN Vol III, p.177, Change 106.

58 e.g. trading or rental income.

59 e.g. the rules in ss.18–19 ITEPA (When general earnings are received).

The Revenue's reply

...

Using your lettering ...

(a) already partly covered by paragraph 8 of SP 5/92;

(b) *it will reduce the relevant income if paid out of income* but will not be a payment [ie not a benefit];

(c) confirmed.[60]

Thus income used to pay interest clearly 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 17.23 (Tracing relevant income).

17.18 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.

17.18.1 *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).[61]

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60 *Taxation Practitioner*, April 1996 p.26, emphasis added.

61 Arguably s.743 ITA would provide relief: see 18.6 (Double counting relief). But this is not a satisfactorily solution as it is not clear who pays the tax.

17.18.2 *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.[62] 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.)

17.19 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.

---

62 The same argument as 17.12 (Is income of life tenant "relevant income"?) but not so strong.

17.20 Relevant income of trust accumulated

17.20.1 *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 income) can be paid or transferred to any beneficiaries.

17.20.2 *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 provides:

(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.

17.20.3 *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,[63] 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 formal process of accumulation should by itself make any difference to the s.731 position. If income of a common form 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.

17.20.4 *Income accumulated and distributed as capital to beneficiary*

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

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63 See 15.14 (Capital receipts deemed to be income).

individual will reduce trust gains and relevant income.

17.21 Relevant income of company distributed

Suppose:

(1) a company within s.731 is held by a common form discretionary trust within s.731;

(2) the company's income is distributed by way of dividend and retained by the trustees.

It is suggested that double counting relief prevents the income from counting as relevant income twice over; see 18.10 (s.731 trust/company structure). But if that is wrong, the distributed income ceases to be relevant income so it is not counted twice.

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.)

17.22 Distributed income: HMRC view

RI 201 states:

> For the purposes of Section 740(3) ICTA 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.

17.23 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 abroad.[64] 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 old relevant income").

(2) The trustees sell the company to a purchaser.

It has been suggested that the old 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 old 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.

17.24 Tracing: are distributions 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

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64 Similar principles apply for the RFI remittance basis. See 9.23 (Terminology) example (4); 9.24 (Tracing unremitted income). A similar principle applies in ascertaining what is income in the definition of power to enjoy; see 16.7.4 (Condition D: possibility of benefit).

not this is the case also 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 be identified as relevant income. But if we must enter this unchartered territory, it is suggested that the remittance basis tracing principles provide a good analogy and should be applied.

17.24.1 *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).

(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 same 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. But if that is right, a distribution to a non-resident or a UK charity can wash trust gains and reduce relevant income at the same time, a result that a Court may be reluctant to accept.

Suppose:

(1) The same 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.[65]

17.24.2 *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 and other company funds together).

(2) The company declares a dividend.

It is considered that the dividend represents the company's distributable profits *pro rata*. If the company has only received income (i.e. has not realised 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.

17.25 Distributing income: tax planning

A common strategy is:

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65 See 9.34 (Remittance from mixed taxed and untaxed income).

(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.[66] It would be better to have an interest in possession trust so income at the trust level will be distributed automatically. It is doubtful whether *Furniss v Dawson* could apply here, but 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.

17.26 Is income of company held by a trust "relevant income"?

17.26.1 *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.[67] 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.

17.26.2 *Income accruing to company before company is acquired by trust*

Suppose:

(1) 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")?

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66 Also (if relevant) it ensures that the settlor receives the benefit of distribution relief; see 18.4 (Distribution relief).

67 In practice the motive defence may apply to the transfer to the company; see 19.32 (Transfer from trustees to trust subsidiary).

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 "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.[68]

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 15.12.1 (Transfer from A to B followed by transfer from B to person abroad).

68 The reference here is to the reference to associated operations in s.732(1)(c).

17.27 Individual not a beneficiary when income arises

17.27.1 *Beneficiary unborn when income arises*

Suppose:

Year 1: a discretionary trust within s.731 receives and accumulates relevant income.

Year 2: a beneficiary is born.

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.[69] 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.

17.27.2 *Individual in existence but not a beneficiary when income arises*

Suppose:

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.

Year 2: an individual ("W") marries a beneficiary and so joins the class of beneficiaries.[70]

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

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69 *Non-Resident Trusts*, 8th ed., para 2.6.5 (Can one avoid the "relevant income" anti-avoidance provisions?).

70 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.

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 contingency 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.

17.27.3 *Beneficiary dead when income arises*

Now suppose the opposite situation:

Year 1: a beneficiary receives a benefit from a trust (which is not taxable for lack of relevant income).

Year 2: the beneficiary dies.

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.

17.28 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.

17.29 Transfers between settlements

Section 90 TCGA provides a code dealing with transfers between settlements for the purposes of section 87 TCGA. This is needed because "trust gains" are computed by reference to "settlements". Each settlement has an amount of "trust gains" 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.

Suppose:

(1) A trust ("trust A") within s.731 has accumulated relevant income.

(2) Trust A transfers funds ("the transferred funds") to a new UK trust on similar terms ("trust B").

(3) A beneficiary ("X") receives a benefit from trust B out of the transferred funds.

The transfer from trust A to trust B is an operation associated with the earlier transfer to trust A. X has received a benefit and the benefit is provided in consequence of the transfer.[71] So X is taxed under s.731.

Suppose trust B was an established trust with a trust fund ("fund B"). If X receives a benefit from fund B he is not taxable under s.731 because that fund is not available in consequence of the transfer of assets to trust A.

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).

17.30 Relevant income must relate to the transfer from which the benefit arises (two transfers of assets)

It is not enough for s.731 that (1) a person receives a benefit and (2) there is relevant income in relation to that beneficiary. Both must relate to the same transfer of assets. Section 732(1)(c) requires:

> (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,
>
> (Emphasis added)

---

71 Or (if this is the test) the benefit is provided out of assets available for the purpose in consequence of the transfer of assets and associated operation.

This has important consequences. Suppose:

(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 a beneficiary.

The beneficiary 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) A beneficiary enjoys the benefit of free occupation in the home.

The beneficiary 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.

17.31 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:

(1) The actual income of the person abroad.

(2) "Relevant income" for s.731.

(3) The income which is deemed to accrue to the UK resident individual who receives a benefit by virtue of s.731 ("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 to be 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 the individual.

(4) A company owned by a non-resident trust.

17.31.1 *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.[72] Then s.731 would not apply[73] and instead the beneficiary will effectively obtain some credit for the UK tax paid by the offshore trust under the regime of Chapter

72 As to how to achieve this, see 8.21 (Payment from trust: income or capital?).
73 See 17.7 (Benefit chargeable to IT defence).

7 part 9 ITA.[74]

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 is generally avoidable in practice and any other rule would certainly be extremely complicated to draft and to administer.

17.31.2 *Purchase of own shares*

The receipt on a purchase of own shares by a UK company is income: see 17.10 (Capital receipts deemed to be 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.

17.31.3 *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 22%, the relevant income is reduced to £78. Once again, s.731 makes no further allowances. So if an individual receives a benefit of £78, on which he is taxed under s.731, he pays tax at the rate of 40% on the £78. The effective rate of tax on the actual income of the person abroad is therefore nearly 55%.

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

74 Unfortunately the credit is less than full credit in the case of dividend income. The regime is too complex to set out here.

from the company. Then s.731 would not apply. The individual would 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%.

17.31.4 *Tax planning by immigration of non-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%.

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.

17.32 Section 731 *v* s.87 TCGA: priority

Section 97(3) TCGA provides:

> The fact that the whole or part of a benefit is by virtue of 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.

Thus the s.731 charge has priority over the s.87 charge provided there is sufficient relevant income in the year of charge.

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 paragraph 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 exceed the 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 paragraph (b).

(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.

(4) 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).

Thus the benefit within s.87 is not later charged to IT. It applies to a foreign domiciled beneficiary even though the benefit was not subject to CGT (because of the s.87 foreign domicile defence) and even though the benefit would not qualify for the s.731 foreign domicile defence.

17.33 Section 731 foreign domicile defence

Section 735 ITA provides:

> **Non-domiciled individuals**
> (1) This section applies if—
> (a) apart from this section, an individual receiving a benefit would be chargeable to income tax under section 731 in respect of any income treated as arising to the individual ("the chargeable amount"), and
> (b) conditions A to C are met.
> (2) Condition A is that the individual is domiciled outside the UK.
> (3) Condition B is that the benefit is not received in the UK.
> (4) Condition C is that, if the individual had received any of the relevant income by reference to which the chargeable amount is determined under section 733, because of being domiciled outside the UK the individual would not have been chargeable to income tax in respect of it.

I call this the s.731 foreign domicile defence.

The relief is in s.735(5) ITA:

> If this section applies, the individual is not chargeable to income tax under section 731 on so much of the chargeable amount as is determined by reference to the relevant income to which condition C applies.

I shall refer to relevant income within Condition C as "excluded relevant income" or excluded RI.

The defence is not a complete exemption to the charge on benefits received outside the UK. It is only that the individual is not chargeable "on so much of the chargeable amount as is determined by reference to excluded relevant income". If there is other relevant income then the benefit received outside the UK can still be charged by reference to that income.

17.34 Where is a benefit received?

The s.731 foreign domicile defence requires one to identify where a benefit is received (or at least, whether it is received in the UK). Just as every asset has a situs (and only one situs), it is considered that every benefit must 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 money paid to a beneficiary's bank account it is received in the place 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.

17.34.1 *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 originally received (ignoring what happens later);

(2) where the money lent (or property representing that money) is situate for the time being;

(3) where the debt is situate under private international law principles.[75].

The main objection to solutions (1) and (2) is that the benefit is not the money lent, it is the interest foregone.[76] It is suggested that the best solution is that the benefit is received where the debt is situate.[77]

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

75 See 46.10 (Simple debt) and 46.12 (Specialties).

76 A further objection to solution (1) is that it only makes sense on the basis of the Flesch view (rejected at para. 17.35) that one cannot remit a benefit. A further objection to solution (2) is the problem of where the benefit of the interest-free loan is received after the money is spent. One could say that the benefit is (presumably for ever after) received where the money is spent, but this is artificial, and only raises further imponderable questions to identify the place where the money is spent.

77 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) since interest is not payable this would be a difficult hypothetical question to answer.

person sold an asset for full value to the individual and left the purchase price outstanding.

17.34.2 *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.

17.34.3 *Release of debt*

Suppose:

(1) money is lent to a beneficiary;[78]

(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 applies on the waiver of interest, but there it is even clearer that solution (1) is not correct.

17.35 Receipt of benefit outside UK and subsequent remittance

Suppose:

(1) a UK resident foreign domiciled individual receives a benefit in the

78 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).

form of the transfer of money (or a chattel) outside the UK, and

(2) later remits that money (or chattel) to the UK.

(The deemed remittance rules discussed below do not apply.) It is considered that the foreign domiciliary's defence ceases to apply and the benefit becomes taxable under s.731.

Michael Flesch QC has argued that all that matters is the place of receipt at the time the benefit is conferred and a subsequent remittance is irrelevant:

> This is because the only benefit Mr. X received was received by him ... *outside* the UK. When, three months later, Mr. X brought the money to the UK he was merely transferring money he already owned from one bank account to another. And that is not, in my view, the receipt of a benefit within section 740(5) ICTA.
> Putting it another way, just as one cannot step into the same river twice,[79] so too one cannot receive the same benefit more than once.[80]

This is a tenable view but on balance I prefer the view that a s.731 charge arises on remittance of a benefit. Looking at the matter technically:

(1) The wording in the s.731 foreign domicile defence is comparable to (and historically based on) the wording of RFI remittance basis ("sums received in the UK"). It is clear that those words cover a receipt outside the UK and subsequent remittance.

(2) My view is more consistent with the application of the deemed remittance rules to the s.731 foreign domicile defence.[81]

One cannot receive the same benefit twice (in the sense that the second receipt is not a new benefit), but one can move a benefit after receipt from A to B, so the same benefit is received in different places. The issue is, perhaps, what is the benefit. Flesch regards the benefit as the *transfer* of

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79 Heraclitus' river *dictum* raises questions about identity and is (deliberately?) provocatively debatable.

80 *GITC Review* Vol 1 Issue 2, p.16, accessible *www.taxbar.com*.

81 See 17.35.1 (Benefit used to repay debt or as security).

the asset, not the asset itself. The transfer can only happen once and cannot change situs. However, it is better to say that the benefit is not the *transfer*, it is the *asset* transferred which (or proceeds representing which) can change situs. A *transfer* cannot have a situs at all.

Look at the matter more broadly, the Flesch view would make the charge relatively easy to avoid by arranging a receipt outside the UK followed by a remittance to the UK.[82] But the 'merits' of the issue are not clear-cut. On my view, 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 could expect a beneficiary (with access to trust documents) to be able to find out what benefits have been received and where. But there is no way that a beneficiary is entitled to find out what benefits received by other beneficiaries have been remitted.

On my view one must consider whether a benefit received outside the UK is later received in the UK. For this purpose RFI remittance rules should be applied. Suppose:

(1) an individual receives a non-UK situate asset;

(2) the individual sells the asset and remits the proceeds.

This is straightforward. The benefit is received in the UK and the s.731 foreign domicile defence ceases to apply.

Suppose:

(1) an individual ("A") receives a non-UK situate asset;

(2) A transfers the asset to another individual ("B") and B remits the asset or its proceeds.

It is reasonably clear that A is not subject to tax under s.731. He can only be subject to tax in respect of his benefit, and he has not received a benefit in the UK: although B has done so.[83]

Does it make any difference if A and B are married? HMRC might argue that it does, as references in s.731 to an individual include the spouse or

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82 Though the *Ramsay* approach would strike down blatant cases.

83 As to whether B might be taxed under s.731, see 17.6 (Benefit causation conditions).

civil partner of the individual: see s.714(4) ITA. It is considered, however, that the deeming provision does not have this effect. The deeming provision is relevant for s.714(4) purposes for ascertaining what is "relevant income" in relation to an individual. That is, income which can be used to benefit the spouse of an individual is relevant income in relation to that individual. However, the deeming provision does not mean that whenever one sees the word "individual" one can substitute the spouse. That makes no sense. For instance, if W receives a benefit, it is W only who can be subject to tax on that benefit. HMRC cannot tax H on the benefit on the grounds that "an individual" (W) is to be identified with H.

17.35.1 *Benefit used to repay debt or used as security*

Suppose:

(1) a benefit is received outside the UK and

(2) the benefit is used to repay a UK-linked debt.[84]

This question takes us to s.735(6) ITA:

> Sections 833 and 834 of ITTOIA 2005 (income treated as remitted to the UK) apply for the purposes of this section as they would apply for the purposes of section 832 of that Act (remittance basis) if the benefit were relevant foreign income.

This incorporates by reference the deemed remittance rules[85] on the counterfactual assumption that the benefit was relevant foreign income. Once amended as s.735(6) requires, section 833(1) ITTOIA provides (so far as relevant):

> For the purposes of [section 731 ITA,] if a person who is ordinarily resident, but is not domiciled, in the UK uses [a benefit] outside the UK to satisfy a UK-linked debt, the person is treated as receiving the [benefit] in the UK at the time when it is so used.

84 i.e. a debt for money lent in the UK (or lent outside the UK and later received in the UK); see 9.40 (UK-linked debt).

85 See 9.39 (Deemed remittances).

A benefit in the form of money received outside the UK and used to repay a UK-linked debt is "treated as received in the UK". So it will no longer qualify for the protection of the s.731 foreign domicile defence.

17.35.2 *Beneficiary changes residence*[86] *after receipt of foreign benefit*

The statute gives no guidance to the position where:

(1) the beneficiary is ordinarily resident when he receives the benefit but not ordinarily resident when the benefit is remitted to the UK; or

(2) the beneficiary is not ordinarily resident when he receives the benefit but is ordinarily resident when it is received in the UK.

This omission offers some support for the Flesch view that a subsequent remittance is not taxable because if it were intended to tax remitted benefits one would have expected a well drafted statute to deal with the point. But there are many points in this area which the legislation does not address.

In table form:

Case No.	**1**	**2**	**3**	**4**
Ord. resident on receipt of benefit	Y	Y	N	N
Ord. resident on receipt in UK	Y	N	Y	N

Cases 1 and 4 raise no difficulty. It is considered that there is no charge in case 3: s.731 suggests the beneficiary must be ordinarily resident at the time when he receives the benefit. It is suggested that there is also no charge in case 2 (beneficiary leaves UK and then remits benefit). This is consistent with the normal remittance basis.[87] So the charge only arises if the beneficiary is ordinarily resident at the time he receives the benefit and at the time it is received in the UK.

86 See too 17.36.5 (Beneficiary changes domicile after receipt of foreign benefit).

87 See 9.18 (Income arising when non-resident, remitted when resident).

17.36 Excluded relevant income

"Excluded relevant income" is my term for income within Condition C in s.735(4) ITA:

> Condition C is that, if the individual had received any of the relevant income by reference to which the chargeable amount is determined under section 733, because of being domiciled outside the UK the individual would not have been chargeable to income tax in respect of it.

This is based on the wording of the s.720 foreign domicile defence[88] and the s.624 foreign domicile defence.[89]

The following is not excluded relevant income:

(1) UK source income;

(2) Irish source income; or

(3) foreign source income which is received in the UK.

To the extent that there is income of that kind, the s.731 foreign domicile defence will not apply: even benefits received out of the UK will be taxable under s.730.

17.36.1 *Foreign income remitted by persons abroad*

Suppose:

(1) Year 1: A trust within s.731 receives foreign income (which is in principle excluded RI).

(2) Year 2: That income is remitted to the UK by the trustees ("remitted income").

Is the remitted income within Condition C? We must imagine that the individual had received the remitted income, and then ask:

88 See 16.14 (s.720 foreign domicile defence).

89 See 14.6 (s.624 foreign domicile defence).

(1) Would the individual have been chargeable in respect of it? and if not

(2) Was the reason that he would not have been chargeable "because of being domiciled outside the UK"?

The answer to the first question may depend on when one asks it. If one asks the question in Year 1, the answer is clearly no, the individual would not be chargeable on the foreign income. But even if one asks the question in Year 2, it is suggested that the answer is still no, the individual would not be chargeable. For although one imagines that the beneficiary received the income, there is no reason to imagine that the beneficiary had remitted the income. The argument is more or less the same as for s. 720: there is no equivalent of the s.648 clawback.[90]

Considerable complications would follow if this were not correct.

17.36.2 *Non-resident beneficiary*

Is relevant income excluded if it arises when the beneficiary is non-resident and non-domiciled?[91] Clearly, if the beneficiary were entitled to relevant income, he would not be chargeable in respect of it. There are two reasons why he would not be chargeable: non-residence and foreign domicile. But it is clearly assumed for the purposes of the foreign domicile defence that such income is excluded relevant income. Any other conclusion would be absurd.

17.36.3 *UK source income*

Suppose:

(1) Year 1: A trust within s.731 receive UK source income ("UK income"). That income is not excluded RI. However no benefits are conferred so there is no s.731 charge.

(2) Year 2: The source of income ceases.

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90 See 16.14 (s.720 foreign domicile defence).

91 For a charge to arise under Section 731 the beneficiary must be ordinarily resident when he receives a benefit, but he does not have to be ordinarily resident when the relevant income arises: see 17.2 (Ordinary residence at time benefit received).

(3) Year 3: A beneficiary receives a benefit.

Is the UK Income within Condition C? We must ask this question:

If the individual had received the relevant income, would he not have been chargeable in respect of it?

If not, one must ask whether the reason for his not being chargeable is that of being non-UK domiciled.

If the beneficiary received the UK income in Year 3, he would arguably not have been chargeable (because the source has ceased) but the reason would have nothing to do with the beneficiary's domicile. So the UK income cannot be excluded RI.

17.36.4 *Distribution of UK source income*

Suppose an offshore company ("OC") within s.731 is owned by a trust within s.731:

Discretionary Trust — *Trustees' Dividend Income (foreign source)*

↑

Offshore Company — *OC's Income (UK source)*

UK Assets

If OC receives and retains UK source income, that is not excluded 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.

17.36.5 *Beneficiary changes domicile*[92] *after receipt of foreign benefit*

Suppose:

92 See 17.35.2 (Beneficiary changes residence after receipt of foreign benefit).

(1) a UK resident foreign domiciled beneficiary receives a benefit outside the UK, and

(2) the beneficiary later becomes UK domiciled.

Income accruing after the change of domicile is not excluded relevant income and so there is in principle a s.731 charge (up to the amount of the benefit). What if the beneficiary remits the benefit to the UK after the change of domicile? There is no guidance in the statute but it is suggested that there is no tax charge: this omission is some support for the Flesch view that no tax charge arises on remittance of a benefit.

17.37 Section 720 and 731 foreign domicile defences compared

Sections 720 and 731 both offer a form of foreign domicile defence. The s.720 defence is less 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 S occupies the same property. S is taxed on the benefit of the rent-free accommodation under s.731. The s.731 foreign domicile defence does not help S because the benefit is received in the UK.

17.38 Summary of responses to s.731

17.38.1 *Basic planning*

(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 but not taxed on the remittance basis).

17.38.2 *Sale of equitable interest scheme*

The following arrangement may be worth considering:

(1) An appointment confers a valuable equitable interest on a foreign domiciled beneficiary, B.

(2) B sells the equitable interest for a capital sum.

Neither the conferring nor the sale of the interest is a benefit within s.731: see 17.4 ("Benefit"). CGT may be avoided if the sale involves the disposal of a non-UK situate asset.[93] Take care on implementation!

93 See 46.26 (Situs of equitable interest under a trust).

CHAPTER EIGHTEEN

TRANSFER OF ASSETS ABROAD: DOUBLE TAXATION ISSUES

18.1 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 have coined the following terminology:

Name of Relief	ITA Section	Outline of Relief
Transferor's credit	745(1)	Credit for tax paid by transferee
Transferee's concessionary credit	Concession	Credit for tax paid by transferor
Distribution relief	743(4)	Relief on distribution to transferor
Double-counting relief	743(1)	Vaguely expressed double taxation relief

18.2 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 appears at first sight that there are two charges to tax:

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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?

18.2.1 *Transferor's credit*

Section 745(1) ITA provides relief for T:

> Income tax at the basic rate, the savings rate 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/lower/dividend ordinary rates). HMRC say:

> You may be liable to income tax on the income received by an overseas company, which you have entered in box 6.4. In certain circumstances such a company may also be liable for UK Corporation Tax on what is effectively 'the same' income. This could happen where the company is registered overseas but is centrally managed and controlled in the UK. If you have returned an amount of income received by such a company at box 6.4, and if UK Corporation Tax has been paid by that company on an equivalent amount of its income, you can claim credit relief for the UK Corporation Tax paid by (and not refunded to) the company on that equivalent amount of company income. You may claim this credit relief at box 6.9 of the Return (that is, together with foreign tax credit relief claims for foreign tax paid). Do not enter the UK Corporation Tax in column C or box 6.3. Give full details of how you have calculated the

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2 This was considered in *R v Dimsey & Allen* 74 TC 263 at para.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."

amount of credit claimed, and details (name, address, tax reference) of the company which paid the tax, in box 6.39 on page F5. If you do not yet know the amount of Corporation Tax paid on the equivalent amount of company income, or if the company has not yet paid all of its liability (for example, if the company's accounting period straddles the Income Tax year end), 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 by ticking box 23.2 of the Return and explaining the circumstances in the 'Additional information' box, box 23.7 (see page 31 of the Tax Return Guide). We will consider providing details of Corporation Tax paid upon receipt of written authority from the company concerned[!]. The usual provisions for charging interest on tax paid late will apply.[3]

18.2.2 *Transferee's concessionary credit*

The limitation of the transferor's credit was explained in *Dimsey & Allen* 74 TC 263 at para.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 *Dimsey & Allen*, HMRC announced a concession to solve this problem:

> **The Inland Revenue's Practice on section 739**
> [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 739 ICTA on the same income;
> [2] and conversely, if in any case tax is paid on any income by the transferor under section 739, the Inland Revenue will not tax the transferee on that income.
> So that in every case, the Treasury received in all the full amount of tax

3 "Notes on Foreign" (the Notes on the Foreign pages of the tax return for the year ended 5 April 2005, under the heading "box 6.4", page FN10). In *R v Dimsey & Allen* 74 TC 263 at para.55 Lord Scott suggested (without deciding) that transferor's credit would apply in this case.

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.[4] One can imagine a situation where T and OC each ask HMRC to assess the other! There is no mechanism for any 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

4 For instance, if OC owes T a small debt.

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.

It is arguable that double-counting relief also provides a defence to double taxation: see 18.6 (Double-counting relief). If this is correct, the transferee's concessionary credit is the law and not a concession.

18.3 Distribution to T of income of company within section 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.[5]

(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 (or by OC and T but with credit to avoid double taxation: see above) under s.720.

(2) IT on the dividend (paid by T) on normal principles.

Is there any relief from economic double taxation?

18.4 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

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5 The position is not materially different if the shares in OC are held in a trust under which T is life tenant.

[b] the individual subsequently receives *that income*,
it is treated as not being the individual's income again for income tax purposes.

(Paragraphing and 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 section 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.[6] Condition (2) is *ex hypothesi* satisfied.

18.4.1 *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 fictional, notional income. The two are not the same. But if that is correct, then s.743(4) can never apply at all, which cannot be correct. The reference to "that income" must be a reference to OC's income.

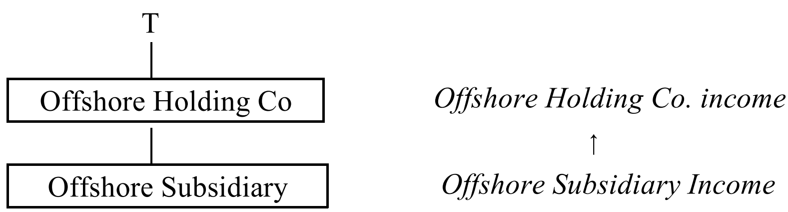
OC's income and the dividend income are in substance or economic reality the same income. But they are usually regarded for tax as separate sources of income, not the same income. "The income of the company and the income derived from the company by the shareholders are two quite different incomes".[7] Nevertheless for this purpose one looks to the

6 See 18.2 (Undistributed income of OC); 18.7.2 (When is individual "charged to tax" under s.720?).

7 *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

substance and does not apply the formalistic view. This would be reasonably clear even in the absence of authority, because (on 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*.[8] The facts were relatively simple. T (UK domiciled) held an offshore holding company (within s.720) which held an offshore subsidiary (within s.720):[9]



(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.

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dividends by its British shareholders are not to any extent or effect one and the same income, but are two distinct incomes".

8 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 concluded 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 16.7.4 (Condition D). For another case where the Court looked at the economic substance in order to determine whether or not two assets were "the same" (for the purposes of stamp duty subsale relief) see *Fitch Lovell v IRC* [1962] 1 WLR 1325.

9 More accurately, there were several holding and subsidiary companies but nothing turns on that.

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:

> 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.

18.4.2 *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.

18.4.3 *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; see 9.34 (Remittance from mixture of taxed and untaxed income).

18.4.4 *Planning implications: advantages of 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.

18.5 Distribution (*not* to T) of income of company within section 720

Suppose:

(1) An offshore company ("OC") within section 720 receives income ("OC's income");

(2) T is not a shareholder in OC but has "power to enjoy" the income;[10]

(3) P (a UK resident third party) owns all the shares;[11]

(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.

(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.

18.6 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[12] under this

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10 He may have power to enjoy by reason, perhaps, of a debenture or through being a beneficiary of the trust which holds OC.

11 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.

12 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

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.

I refer to this as double-counting relief. This provision is vaguely worded, but I suggest it prevents double taxation:

(1) By double application of s.720; if there are two transferors (but *Vestey* suggests that there can only be one transferor).

(2) By double application of s.731; e.g. where two different individuals receive benefits.

(3) By application of s.720 and s.731.[13]

(4) By application of general principles and ss.720 and 731.

This therefore applies in the circumstances of the example of paragraph 18.5 (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

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 section727 (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.

13 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.73, 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 17.14 (Is income within s.720 relevant income?).

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.

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".[14]

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.

18.7 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:

14 Cited "*R v Halliday* in Retrospect" [2003] LQR 455 (David Foxton).

Settlor/Transferor (“T”)

⋮

Discretionary Trust		*Trustees’ Dividend Income*
|		↑
Offshore Company		*OC’s Income*
|		
Assets		

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)”).

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?

18.7.1 *Distribution relief*

It will be recalled that distribution relief applies if:[15]

(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);

15 See 18.4 (Distribution relief).

(4) the individual is charged to income tax on OC's income under section 720.

Condition (1) is satisfied. Condition (2) is satisfied because income is treated as received by T. Condition (3) is also satisfied: see 18.4.1 (When is income "the same"?).

18.7.2 *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*[16] 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.

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.[17]

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16 See 18.4.1 (When is income "the same"?).

17 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

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:

(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.

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voluntarily pay."
Whitney v IRC 10 TC 87 at 109.

(2) It may also affect the year in which the income is subject to tax.

18.7.3 *Double-counting relief*

This provision is discussed in 18.6 (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.

18.7.4 *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 739 ICTA 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.

18.7.5 *Trust/company structure: further example*

In the trust/company structure illustrated at 18.7 (Section 720 trust/company structures) 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.

18.8 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[18] have been double taxation:

18 Arguably relief is available under s.527 ITTOIA.

(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 events provisions.

The Special Commissioners noted correctly that distribution relief did not apply. The 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.

18.9 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;

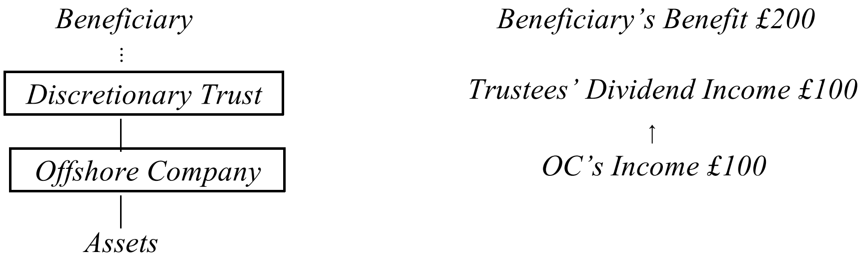
(3) the income is later distributed to the beneficiary as income.

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.

18.10 Section 731 trust/company structure[19]

The problem is best illustrated by example:

19 Contrast 18.7 (s.720 trust/company 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 18.6 (Double-counting relief).[20]

18.11 Double Taxation Relief: Treaties

On this topic see 32.6 (DTTs and TAA provisions).

20 If that is wrong, then a second argument is that after the company's income is distributed it ceases to be relevant income. See 17.21 (Company income distributed). 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 NINETEEN

TRANSFER OF ASSETS ABROAD: MOTIVE DEFENCE

19.1 Introduction

Sections 736 to 742 ITA provide a defence to the TAA provisions called "the motive defence".[1] This area of law was difficult before 2006, but the FA 2006 made it almost twice as complicated: it introduced stricter rules which apply to transactions from 5 December 2005, while retaining the old rules for earlier transactions.

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.

19.2 Terminology

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.

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1 The word "motive" is not used in the legislation, but the label is convenient, not seriously misleading, and originates from the Inland Revenue's Notes on clause 18 Finance Bill 1936.

In this chapter:

(1) "Old Conditions A and B" are the conditions called conditions A and B in s.739 ITA.

(2) "New Conditions A and B" are the conditions called conditions A and B in s.737 ITA.

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:

(3) EN Draft Clauses (2005); and

(4) EN FB 2006.

(5) An "innocent" transfer is one which satisfies Condition A or B (in short, no tax avoidance purpose).

(6) A "tainted" transaction is one which does not satisfy Condition A or B.

19.3 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.

19.4 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) 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.

19.5 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.[2]

The Solicitor-General explained why the text was changed to (what is now) Old Conditions A & B:

> A taxpayer[3] 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.[4]

A case on similar facts might still succeed today, but the test is stiffer.

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2 Section 18 FA 1936. Section 28 FA 1938 substituted the text which is now Old Conditions A and B.

3 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.

4 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.

The taxpayer would need to show that tax avoidance was not even one of the purposes of the transfer (Condition A).[5]

19.6 "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 and difficult word.[6] 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.

19.6.1 *Non-business transactions*

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.[7]

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 19.5 (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-

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5 Alternatively one might argue that the transfer was commercial (Condition B) but that is not so on the view adopted in this book.

6 *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.

7 [2000] STC (SCD) 143 at 166.

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.

19.6.2 *Making or managing investments*

In HMRC's view:

> The expression "bona fide commercial" in Section 741(b) ICTA is taken to apply [1] only to the furtherance of trade or business, and [2] not to the making or managing of investments.[8]

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.[9] I guess that the intended meaning is, that investment transactions which constitute a business are commercial, but investment transactions which do not constitute 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 362:

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8 RI 201, paragraphing added. 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.

9 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.

> 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 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.

19.6.3 *Transfer with element of bounty*

A transaction with an element of benevolence or bounty is not commercial.[10] The concept of bounty (unlike "commercial") is relatively

10 *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

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.[11]

19.6.4 *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 case where there is an 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.[12]

The point was not discussed on appeal.

19.7 "Commercial" in New Condition B

Section 738 ITA contains a partial definition of "commercial" for the

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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").

11 This is supported by *Wannell v Rothwell* 68 TC 719 at 733B, a case on loss relief which uses the word "commercial"; and *IRC v Levy* 56 TC 68. The issue arose in *Levy* because the Courts at one time adopted the view that the concept of "settlement" for the purposes of the settlement provisions excluded commercial transactions. (In *IRC v Plummer* 54 TC 1 Lord Wilberforce rejected this view, though some subsequent cases have nevertheless regarded it with favour. We need not be concerned with that here: what matters is the sense which the Courts gave to the expression "commercial" when they used it.)

12 70 TC at p.86H.

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—
> (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".[13]

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 shares. 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.

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,

13 For HMRC views on what constitutes a business, see CG Manual para.65712 and Shares Valuation Manual para.27170.

> are persons not connected[14] 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 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 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 an investment

14 "Connected" is defined in s.993 ITA.

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.

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.

19.8 "Avoidance", "mitigation", "tax reduction", "evasion": introduction[15]

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 erroneous 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

15 For further reading, see Nabil Orow, *General Anti-Avoidance Rules* (Jordans, 2000). This has an extensive bibliography.

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 be possible without them. However, all four concepts and their associated terminology have only emerged after a gradual process of development. It is essential to bear this in mind on reading sources on this subject.[16]

19.8.1 *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)[17]. In 1900 the distinction was noted as two meanings of the word "evade".[18] The technical use of the words avoidance/evasion in the

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16 e.g. the 1920 Royal Commission on the Income Tax 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 Cmd. 615 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.

17 *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.

18 *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."

modern sense originated in the USA where it was well established by the 1920s.[19] It was slow to be accepted in the UK. By the 1950s, knowledgeable and careful writers in the UK had come to distinguish the term "tax evasion" from "avoidance/mitigation".[20] 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.[21] Now that the

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19 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 U.S. 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 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 s.739).

20 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 now 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."

21 Examples include: *Coutts & Co v IRC* [1963] 2 WLR at 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 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

terminology has received official approval in the UK[22] this usage can be condemned as erroneous (but it still happens).[23] But it is sometimes helpful to use the expressions "legal avoidance"[24] and "illegal evasion", to make the meaning clearer.

19.8.2 *Avoidance/mitigation distinction*

The clear[25] articulation of the *concept* of an avoidance/mitigation distinction goes back only to the 1970s[26] 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

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 concepts either because avoidance was not seen by some as moral or because evasion was not seen by some as immoral; the book did not suggest a lack of a legal distinction which was unquestioned then and still should be now.)

22 *Craven v White* (1988) 62 TC 1 at 197; OED 2nd edition (1989) entry under "Taxation."

23 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 para. 50. This is perhaps due to inadequate translation.

24 "Legal avoidance" is a standard term in recent double tax conventions.

25 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.

26 In 1946, Wrottesley J was unaware of it in a s.741 context: "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).

> 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 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'*.[27]

The use of the terminology avoidance/mitigation to *express* this distinction is an innovation of Lord Templeman in 1986.[28] The expression "tax avoidance" has very often been used in the loose sense, meaning or including mitigation[29]. The reason may be either that the author does not

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27 *Hidden Costs of Taxation*, IFS, 1973, page 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.

28 *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.

29 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)

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 often jocular, which suggests that the technical meaning is seeping into public consciousness.[30] Likewise "mitigation" was and sometimes still is used in the sense of "avoidance".[31]

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",[32] "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.

19.9 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. Tax avoidance was to be distinguished from tax mitigation. ... My Lords, I am content for my part to adopt

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30 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."

31 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 203 (a requirement of *Furniss v Dawson* is that a transaction "had no other purpose than tax mitigation").

32 See s.748(3) ICTA (Controlled Foreign Companies). HMRC's Guidance Note on the CFC legislation provides at INTM208010:

> "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' ...".

See *www.hmrc.gov.uk/ctsacfc/.*

> these propositions.[33]

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 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. The best way[34] to reach that result is to give a narrow meaning to tax avoidance and so to widen the motive defence.

19.9.1 *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.

19.10 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. This is the HMRC view: 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.

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33 [1997] STC 995 at p.1003.

34 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 19.15.1 (A choice principle?).

Sassoon, though criticised,[35] is a decision of the Court of Appeal and 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 any revenue for whose collection and management the Commissioners for Her Majesty's Revenue and Customs are responsible.

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

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35 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 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 19.22 (Practical examples).

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.

managed by a different Government department).

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 (where the distinction would depend on the foreign tax culture and attitudes).

19.11 Identifying and classifying "purpose": the old conditions

It is submitted that the identification of a tax avoidance purpose requires a two-stage approach: identifying and classifying purpose.

19.11.1 *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".[36] 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".[37]

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.

19.11.2 *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 Special Commissioners 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).

19.11.3 *HMRC view*

RI 201 states:

> [1] If a transaction involves tax avoidance, that is considered by the Revenue to be at least one of its purposes

36 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.

37 See 19.14 (Foresight and purpose) and 19.15 (Subsidiary consequence not necessarily a purpose).

[2] even if the transferor did not form the subjective intention[38] of avoiding tax.[39]

This is clearly 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.[40] 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.[41]

While the HMRC statement clearly rejects a subjective purpose test, it is

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38 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."

39 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."

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> "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 p 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. A subjective test also applies for the escape clause in s.703; see *Addy v IRC* 51 TC 71 at p.81E.

41 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.

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 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; see 19.5 (Enactment history). 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 want 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*,[42] *Carvill v IRC*.[43] At present HMRC contend these decisions were wrongly decided and the point may reach the courts. 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 transactions. But there is (of course) no official recognition of this in the published statements and we will have to wait and see.

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42 "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.

43 [2000] STC (SCD) 143 at paras. 9–13. 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*). *Carvill* was followed in *4Cast v Mitchell* [2005] STC (SCD) 280.

19.12 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 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 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.[44]

These paragraphs are somewhat muddled. I think it is making the point made at 19.11.1 (Identify purpose). 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 in fact 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

(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.

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44 EN Draft Clauses (2005). The point is made more briefly in EN FB 2006 para.66.

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.

19.13 Transfer made for tax and non-tax purposes

19.13.1 *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.[45]

19.13.2 *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[46] too generous to HMRC. The Special Commissioner stated the law in *Carvill v IRC* [2000] STC (SCD) 143 at 166:

> 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

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45 This is stated in *Philippi v IRC* 47 TC 75 at p.110, but it is plain from the terms of the statute.

46 Depending to an extent what nuance one gives to the malleable word "significant".

> 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.

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.

19.13.3 *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.[47] 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, the circumstance in which a claim which fails Condition A still qualifies under Condition B will be extremely rare. New Condition B is almost a dead letter. Since the "commercial" requirement in New Condition B is so narrow, it will not often matter.

19.14 Foresight and purpose

19.14.1 *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

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47 I take "more than incidental" in New Condition B to have the same meaning as "significant" in RI 201.

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".[48] It recognises that a person may not have the purpose of causing a tax saving result if he has the purpose of causing another result even though he knows the tax saving would occur if he succeeds in his purpose of causing the other result.

"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 ...
> [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.[49]

Here the word "purpose" is understood in the same sense as "intention" (as defined above, i.e. foresight does count as purpose) and (I think) "object" is used in the narrower sense.[50]

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48 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.

49 *Chandler v DPP* [1964] AC 763 at 804, emphasis added.

50 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 688. See John Avery Jones "The mental element in anti-avoidance legislation" [1983] BTR 22.

19.14.2 *"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.[51]

This adopts (I think) the narrower concept of purpose and it is suggested that this is the law. 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.[52]

19.15 Subsidiary consequence not necessarily a purpose

This was stated judicially in the "celebrated"[53] passage in *IRC v Brebner*:

> [1] My Lords, I would only conclude my speech[54] 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

51 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".

52 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.

53 *IRC v Willoughby* [1995] STC at p.167.

54 For completeness, the TC report reads "judgment" and the AC reads "speech". "Speech" is strictly the correct term.

> 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.[55]

The point being made here is not (or not just) that mere foresight of a tax advantage is not a tax avoidance purpose[56]. Lord Upjohn goes further in point [2]: 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[57] 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.

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55 *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.)

56 The point made at 19.14 (Foresight and purpose).

57 *Brebner* is a s.703 ICTA case. The wording of s. 703 ICTA is not quite the same as Condition A: s.703 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 considered in a Condition A context.

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 not 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.[58] In practice, this issue arises in Condition A cases.[59] 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 (suggesting 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.

19.15.1 *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

58 *Mangin v IRC* [1971] AC 739 at 751 and 756, restating the *Brebner* principle in the context of an extremely free reading of a New Zealand provision.

59 Because in a commercial transaction, incidental tax avoidance purposes are in any event disregarded.

– is not avoidance.[60]

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.[61]

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".[62]

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)[63]; and

(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).[64]

This does not work, because classifying a transfer in category (1) or (2) is an arbitrary or evaluative exercise.

19.16 Purpose of 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:

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60 Philip Baker QC "Tax avoidance, tax mitigation and tax evasion", accessible *www.taxbar.com*.

61 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*.

62 See 19.17.2 (Special tax regime).

63 Such as the saving of the settlor's own tax liabilities arising from the transfer; see 19.23.1 (No avoidance of settlor's tax liabilities).

64 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).

(1) a company makes a transfer, and

(2) there is no quasi transferor,[65]

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, 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".[66]

For the purposes of New Conditions A and B, section 737(5) (6) ITA provides:

> (5) In determining the purposes for which the relevant transactions or

65 In such a case of course there would be no *individual* "transferor" who is within s.720: see 16.3.2 (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.

66 57 TC 1 at p.47,49. The same principle applies for s.703 ICTA; see *Addy v IRC* 51 TC 71 at p.81g. Likewise for the settlement provisions: see 45.23 (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 said it was "both possible and appropriate to attribute the purpose of a professional advisor to the taxpayer". This point was not 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 hence not considered; it remains open to argue in another case.

> 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.

19.17 Avoidance/mitigation distinction

This section sets out the most important judicial and other statements on the avoidance/mitigation distinction.

19.17.1 *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 Parliament.[67]

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.[68]

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

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67 70 TC 57 at p.117.

68 Tax avoidance: A Report by the Tax Law Review Committee (1997) para. 1.13, citing *IRC v Willoughby*.

avoidance produced by the Tax Law Review Committee in 1997.[69]

There have been some attempts to be more specific.

19.17.2 *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 seem reasonably clear[70] examples 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[71] 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. [72]

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69 IR152 Trusts: An Introduction accessible *www.hmrc.gov.uk/pdfs/ir152.htm*. HMRC have tried to alter the nuance by deleting the words "plainly" and "possibly" from the TLRC formulation, but that does not alter its essential nature.

70 Though it might be argued that Parliament had intended the chargeable events regime for normal bonds but not for personal portfolio bonds.

71 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".

72 *O'Neil v Commissioner of Inland Revenue* [2001] STC 742.

19.17.3 *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.[73]

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 if he had.[74]

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

73 70 TC at 116 (emphasis added).

74 *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.)

> 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.[75]

These are transactions with obvious economic consequences.

It is curious that Lord Nolan emphasised this test, because Professor Willoughby's investment in his bond had no substantial "economic consequences" as compared to a direct investment in the underlying assets.[76]

Incidentally, one wonders what economists would think of the term "economic consequences". One suspects it is what John Kay derides as "DIY economics".[77]

19.17.4 *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 are:

(1) confidentiality from other promoters; and

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75 *IRC v Challenge* [1986] STC at 554–5.

76 Lord Nolan did seek, somewhat unconvincingly, to identify 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."

77 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.

(2) premium fees (typically linked to tax savings).

The OECD also identified secrecy[78] 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.[79]

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

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78 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 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.

79 OECD Report by Committee of Fiscal Affairs (1980) cited in OECD International Tax Avoidance and Evasion (1987), page 17.

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 refused to regard bed-and-breakfast transactions or back-to-back loans as tax avoidance.[80] 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.[81]

Category (1) is obviously mitigation and category (3) is obviously avoidance. It is suggested that category (2) should not be regarded as 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.[82] 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).

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80 *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.

81 *Tax Avoision* (1979, IEA) p 81.

82 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.

19.18 Failed indicia of tax avoidance

19.18.1 *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*.[83] Either way, the expression is best avoided in our context.

19.18.2 *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 without much (if any) artificiality[84] 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.[85]

The Royal Commission is right. The problem is not that the word

83 "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.

84 e.g. an appointment of non-resident trustees.

85 Cmd. 9474 para 1024.

"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.[86]

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".[87]

19.18.3 *"Genuine"*

The word "genuine" is often used to describe the antithesis to a tax avoidance transaction.[88]

19.19 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):

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86 Cited in 'Victorian Wives and Property' Lee Holford, in *A Widening Sphere* Ed Vicinus, Methuen, 1980. The proposal did not become law until 1882.

87 *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."

88 For example see 19.26 (UK settlor and UK beneficiaries) and 41.16.3 (Asset yielding a loss).

> 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.[89] 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.

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)

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89 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.

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 partly: *to what materials* does one refer to ascertain these values? I will give 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.[90]

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

90 *Hidden Costs of Taxation*, IFS, 1973, page 113.

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).

19.20 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 arrangement 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.[91]

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.

19.20.1 *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 construction of any statute is always said to be to find "the intention of Parliament".[92] A successful tax avoidance scheme, even as blatant a

91 *Hidden Costs of Taxation*, IFS, 1973, page 114 (emphasis in original).

92 See *Cross on Statutory Interpretation*, 3rd ed., 1995, chapter 2.

scheme as *Fitzwilliam*,[93] 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.[94]

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.

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".[95] A.A. Shenfield recognised this (perhaps grudgingly):

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93 67 TC 614.

94 A.A. Shenfield, *The Political Economy of Tax Avoidance*, Institute of Economic Affairs, Occasional Paper 24, 1968, p.20–1.

95 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).

> 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 ...[96]

19.21 Reduction, deferral and unsuccessful avoidance

19.21.1 *Reduction*

The motive defence provisions refer to "avoidance" alone but comparable statutory provisions refer to "avoidance *or reduction*" of tax.[97] In this expression it could be that avoidance is used in the strict sense and 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.[98] 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.

19.21.2 *Deferral*

Arrangements to defer tax may constitute "avoidance".[99] 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

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96 *Ibid*, note 94 .

97 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.

98 Contrast the statutory expression "mitigate or remit" a penalty.

99 The Special Commissioner so held in *IRC v Willoughby* 70 TC at p.84. There was wisely no appeal on this point.

conclusion that the arrangement is to be characterised as mitigation and not avoidance.)

19.21.3 *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.[100]

19.22 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"):

(1) Trusts where settlor is excluded:[101]
- (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)

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100 OECD Report by Committee of Fiscal Affairs (1980) cited in OECD's International Tax Avoidance and Evasion (1987), page 17.

101 It is assumed that the spouse of the settlor is also excluded.

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.[102]

However, a tax charge does not arise in isolation, but is charged in different ways on the settlor, trustees[103] 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 3 sub-issues raises 9 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 purpose to save IT/CGT/IHT by settlor/trustees/beneficiaries and, if so, is it mitigation or avoidance?).

19.23 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:

19.23.1 *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.[104] However, HMRC rightly say that the purpose of a trust transfer may be to avoid tax

102 See 19.10 (Meaning of "taxation").

103 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.

104 See Lord Templeman's dictum in 19.17.3 (Economic consequences). The exceptional case of s.86 TCGA is discussed below.

liabilities of the trustees and beneficiaries and here closer investigation is needed.

19.23.2 *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.

19.24 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 the settlor.

19.24.1 *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) will not in principle yield any greater CGT before 2007/08.[105] There is no question of CGT avoidance for dispositions before the FA 2006.

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105 As long as the UK trustees were professionals: see the fourth edition of this book at 5.8 (Professional trustees treated as non-resident).

The position is slightly more complicated after the FA 2006. The choice of exclusively UK trustees of a discretionary trust will yield HMRC CGT and some income tax on foreign source income not due from non-resident or mixed resident trustees.[106] However, if one trustee (even a minority trustee) is resident outside the UK, the trust is 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 liability. Any tax saving here must be mitigation.

19.24.2 *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.[107]

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

106 See 5.5 (Trust residence for income tax). The IT position 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.

107 See 19.14 (Foresight and purpose).

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.

19.24.3 *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[108] a difference with "economic consequences". On an economic consequences test this should be mitigation.

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;[109] it is impossible for the settlor to make a discretionary trust anywhere without tax avoidance elsewhere – which, if not absurd, is somewhat startling.

19.24.4 *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. 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.

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108 It would be different if the trustees (perhaps guided by a strongly worded letter of wishes) closely follow the wishes of a beneficiary.

109 Assuming they are in a jurisdiction with a tax system comparable to the UK.

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.

19.25 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.

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.[110]

In these (factually unusual) circumstances the question arises whether the tax saving purpose is avoidance or mitigation. Section 69(2) TCGA and s.474 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.

19.26 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

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110 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.

reasons, and the choice is UK or offshore. 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).

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.[111]

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![112]

19.27 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.

19.28 UK settlor; UK & 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

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111 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.

112 See 19.18 (Failed indicia of tax avoidance).

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.)

19.29 Transfer to trust; settlor a beneficiary

19.29.1 *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[113] 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. It is suggested that there is no CGT "avoidance". This is a "statutory invitation" in plain terms.

19.29.2 *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. The question of avoidance/mitigation does not then arise.

113 See 30.14 (CGT planning).

19.30 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[114]). 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.

19.31 When is a trust transfer made for the purpose of avoiding IHT?[115]

19.31.1 *Change of situs without alteration of ownership*

The transfer of money by a foreign domiciled person from a UK bank to

114 There is no particular significance in selecting five years as illustrative of a medium term period, but it is consistent with the rule that an individual leaving for any shorter period now remains within the scope of CGT: s.10A TCGA.

115 For transfers before 27 March 1974 it would be necessary to consider Estate Duty.

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 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.

19.31.2 *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[116] 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 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.[117]

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.[118]

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116 See 19.23.1 (No avoidance of settlor's tax liabilities).

117 The avoidance/mitigation issue did not arise in *Beneficiary v IRC* [1999] STC (SCD) 134, because the Special Commissioners held that reducing IHT was not a purpose in the mind of the transferor.

118 See 35.13 (GWR to discretionary trust).

19.32 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.

19.32.1 *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.

(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[119], the conclusion that the transfer has a

119 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.

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.

19.32.2 *Is the transfer for tax avoidance?*

Transfer of UK assets[120] 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).

This should normally[121] 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,[122] and a possible income tax disadvantage,[123] so any tax reduction may be regarded as part of a "package deal", with advantages and disadvantages. This does not savour of tax "avoidance".

(2) Escaping additional rate income tax (on UK source income of discretionary trust).

The striking thing about this tax is that there is generally[124] no effective

120 Similar considerations apply to a transfer of foreign assets with a view to realisation and re-investment in UK assets.

121 An exceptional case would be if the property was put in the company shortly before a ten year anniversary and taken out shortly thereafter.

122 Doubling up of trust gains, with serious implications under s.87 TCGA.

123 Loss of tax credits and double taxation relief; sometimes, possible charge under income tax benefit in kind rules.

124 Except in the case of UK land.

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.[125] 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.

19.32.3 *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.

19.32.4 *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.

19.33 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.

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125 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.

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.

19.34 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[126] is avoidance if the transferor has power to enjoy the income, but it is mitigation if he is excluded.

19.35 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.[127] This is a commercial transaction and clearly satisfies Old Condition B. New Condition B is (almost) a dead letter,[128] 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

126 See 9.49 (Source ceasing)
127 See 29.14 (CGT planning before acquisition of asset).
128 See 19.13.3 (New Condition B).

claim for the motive defence is weak.

19.36 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".

19.37 Time to ascertain purpose and change of purpose of transferor

What matters is the purpose of the transferor at the time of the transfer.[129] 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 paragraphs 19.39–40 (Associated operations and the motive defence).

(3) There may be a change of purpose without any new transfer or associated operation. In that case the motive defence remains

129 The point was made in *Herdman v IRC* 45 TC 394; but it is plain from the terms of the statute.

available and the transfer of assets provisions do not bite at all.

19.38 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.[130] 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).

19.38.1 *Transfer by non-resident before 1996*

Parliament decided in 1936 not to apply s.720 ITA to transfers made by non-ordinarily[131] resident transferors, and that was (after some vacillation) held to be the law.[132] 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.[133] 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.[134] 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-

130 See 19.37 (Time to ascertain purpose).

131 For convenience, non-resident is hereafter used to mean non-ordinarily resident.

132 See 16.6.2 (Transferor not ordinarily resident).

133 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.

134 s.81 FA 1997. There is an exemption only for income arising before 1996.

resident may be for income tax avoidance[135] and, of course, a pre-1996 transfer made for CGT or IHT avoidance would also be caught.

19.38.2 *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.[136] So such a transfer should not constitute income tax avoidance. In 1981 Parliament brought in s.731 ITA which applied to pre-1981 transfers.[137] 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.

19.39 Associated operations & motive defence before 5 December 2005

The motive defence is relatively straightforward when there is a single transfer. It is more complicated if there are also associated operations to consider.

Old Condition A provides:

> that the purpose of avoiding liability to taxation was not the purpose or one of the purposes for which the transfer *or associated operations or*

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135 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.

136 See 15.3 (Which individual?).

137 s.45 FA 1981; there is an exception for income arising before 1981.

> *any of them* were effected.

Old Condition B provides:

> that the transfer *and any associated operations* were bona fide commercial transactions and were not designed for the purpose of avoiding liability to taxation.
>
> (Emphasis added)

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* associated operations". However, in the context of the Old Conditions, 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.[138]

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) Assets were sold to an Irish company in consideration of 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

138 See 15.11 (Significance of associated operations).

UK tax avoidance.[139]

The motive defence was upheld. Lord Reid said:

> It was admitted by Counsel that [what is now s. 720] can only apply if the Respondent 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. I cannot see how it can be said that the Respondent 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 the Respondent's rights.[140]

This needs to be translated to reflect the current wording, which was rewritten in 1969.

Income did not arise to the person abroad in consequence of the associated operation and the transferor did not acquire power to enjoy in consequence of it.

In *Carvill v IRC*:[141]

(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.

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139 After *Willoughby* it should be regarded as mitigation and not avoidance.

140 45 TC at p.413.

141 [2000] STC (SCD) 143 para 80–85.

Steps (2) and (3) were held not to be associated operations, but if they had been associated operations it would not have mattered as they were not relevant. No income arose to B Ltd because of the "operations" and T did not acquire a power to enjoy because of them.[142]

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 s 741 ICTA were satisfied. The amendment to the legislation sought to bring all associated operations into consideration when s 741 was invoked. Because of doubts expressed as to the effectiveness of this amendment,[143] it has been the Revenue's practice in considering whether a defence under s 741 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 742(2) ICTA.*
>
> (Emphasis added)

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)[144] 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 relevant (since it causes income to accrue to the person abroad) so the motive defence does not apply.

Suppose:

142 See paras.81-83.

143 [Author's note] HMRC formerly argued that the law was altered by the FA 1969. See also the obiter comment of Morritt LJ 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.

144 See 15.12.2 and 15.12.4 (Transfer to UK trust followed by migration of trust).

(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 company is not caught by the TAA provisions as the motive defence applies.

(2) T transfers the shares in that non-resident company to an offshore 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 relevant for the purposes of s.720. 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.

Take the same transactions, but assume that the first transfer had a tax avoidance motive, and the second transfer was innocent. The motive defence plainly does not apply. It is not enough to find an innocent associated operation. So income of the company is within the TAA provisions. 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).

19.40 Associated operations & motive defence after 4 December 2005

To understand the reason for the 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 in Hansard, 17 July 1969, column 955–6:

> 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 *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.

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.

The 1969 Act failed to achieve its intention, but 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) 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.

EN Draft Clauses (2005) explained:

> certain associated operations that might potentially be disregarded when applying the current section 741 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.[145]

A 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.

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145 Para.62.The explanation in EN FB 2006 is more curtailed. The provision alters the former law. EN Draft Clauses (2005) claimed 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.

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 very 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.

19.40.1 *Which associated operations count?*

The difficulty with the current law is to identify what counts as "any associated operations" 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 operation associated with the 2000 transfer. See 15.10 (Associated operations). It cannot be that the Crusader's (arguable)[146] 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 similar to 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.[147]

19.40.2 *When do associated operations have a tax avoidance purpose?*

Buying and selling trust investments in the ordinary course of managing

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146 Feudal duties would be "taxation"; see 19.10 (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 or a combination of the two?).

147 See 15.12.1 (Transfer from A to B followed by transfer to person abroad).

a portfolio of investments will fall within Condition A.

Suppose the trustees wish to invest in UK equities, but choose to 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, and Condition A is satisfied. It is considered that the position is the same if they chose a non-UK unit trust or OEIC to avoid UK source income.

Retention of income within a company is probably not an "operation" but even if it is, it would not be tax avoidance. Accumulation of income in a common form discretionary trust[148] is probably 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) comes to the UK. The trustees pay or lend capital to that beneficiary instead of distributing income. It is considered this is not tax avoidance. An arrangement may 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.[149] 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.[150]

Suppose a discretionary settlor-interested trust is within the motive defence, and later 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). Is this tax avoidance? It is considered that the answer is, no. Suppose the trustees also make capital payments to the settlor. Is this tax avoidance? It is suggested that the answer is, no.

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 additional rate of income tax on the rent. It is suggested 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.

148 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".

149 Alternatively the loan in such a case may in fact be categorised as an income distribution.

150 Alternatively the distribution may in fact be categorised as income.

Note the extreme consequences if these views are wrong. If the associated operation concerns only a small amount, nevertheless 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.

19.41 What post-operation income falls within s.720?

Where there is a tainted operation, 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[151] 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

151 "Liable to tax" is defined in s.741(5):
"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."

satisfied. It has already been noted that New Condition B is hardly ever satisfied. Section 741 continues:

> (3) This subsection applies if the income by reference to which the individual is liable to tax for the taxable year is attributable—
> (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 paragraph (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.

19.42 Transitional rules: post-4 December 2005 transfers

This section considers how the TAA provisions apply where an innocent transfer made on or after 5 December 2005 is followed by a tainted operation at any time subsequently.

The position where a pre-5 December 2005 transfer is followed by a tainted operation on or after 5 December 2005 raises additional transitional problems, discussed at 19.48 (Transitional rules: pre-5 December 2005 transfers).

19.42.1 *Income before associated 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 the intention is that only income of the year in the year of the tainted operation and subsequent years is charged.

The letter provides:

> **1. Transitional arrangements, whether income charged retrospectively**
>
> Representation: It is suggested that the transitional arrangements of section 741C have the effect that income could be brought into charge retrospectively. Rule 1 in subsection (6) could be interpreted as meaning that if an associated operation after 5 December 2005 fails the exemption test in section 741A, 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. Subsection (4) of section 741C provides the general rule that section 739 applies in this type of case as it would apply apart from section 741 to 741C. In those circumstances section 739 would take the income arising in the relevant year of assessment. (For completeness, rule 1 in subsection (6) of section 741C 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.)

This is far from clear in the legislation, but it is a sensible result.

19.42.2 *Income before associated operation: s.731*

Suppose:

(1) An innocent transfer was made on or after 5 December 2005.

(2) A tainted associated operation is made.

(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.

(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 works.

19.43 Life policies

The tax motive defence applies to gains from life policies in the same way it applies to ordinary income.

19.44 Motive defence claim in tax return[152]

The motive defence does not require a formal claim. 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.

HMRC say in RI 201:

152 See also 15.16 (Disclosure of TAA issues in tax return).

> Taxpayers are required to disclose clearly in their self-assessment return if there is any income or benefit assessable under s 739 or 740 ICTA , and whether reliance is being placed on s 741 ICTA to exclude income or benefit from assessment.

In the 2005/06 tax return, a claim for the motive defence is made by ticking box 6.5A in the Foreign section of the return. The words next to box 6.5A state with misleading concision:

> Tick box 6.5A if you are *omitting income* from boxes 6.4, 6.4A or 6.5 - see Notes, pages FN11 to FN12.

The Notes to this box ("Notes on Foreign" p.12) explain the meaning of this:

> The provisions relating to transfers of assets do not apply if you can show 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 6.4, 6.4A or 6.5 you must
> [1] tick box 6.5A and
> [2] enter details of the income omitted, together with details of the assets transferred and details of the offshore trusts, companies, etc. involved, in the 'Additional information' box, box 6.39 on page F5.

The comment at [1] shows 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.

As to [2], there is strictly no obligation to give full details, but it would be sensible to give sufficient details to allow HMRC to review the claim. I see no reason to give precise figures for the income which (assuming the claim is valid) will not be taxable but if estimated figures are given, this should be stated. Once a claim is agreed, I see no reason to give any details at all in subsequent tax returns, except, possibly, a note that the motive defence claim was agreed.

19.44.1 *HMRC action when box 6.5A 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 Section 741 ICTA. Claims to Section 741 may appear as a tick in Box 6.5A on the Foreign Pages of the Self Assessment Return. The "white spaces" of a return may contain additional information about a Section 741 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.

19.45 Dealing with HMRC enquiries

The individual must "satisfy an officer of the Revenue and Customs that" Condition A or B is met.[153] This imposes the burden of proof on the taxpayer. That makes no practical difference as the burden of proof generally rests on the taxpayer, and in any event, disputes are rarely decided by the burden of proof.[154]

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

153 ss. 737(2), 739(2) ITA.
154 See 3.4.3 (Proof of intention).

at least, on whether the parties regarded the matter as tax avoidance.[155] 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.

19.46 Appeals

Section 751 ITA provides:

> **751 Special Commissioners' jurisdiction on appeals**
> The jurisdiction of the Special Commissioners on any appeal 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 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),

155 See 19.17.4 (Indicia of avoidance).

(e) section 743(2) (no duplication of charges: choice of persons in relation to whom income is taken into account).

The new wording makes clear that jurisdiction of the Special Commissioners 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 Special Commissioners 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 a Special Commissioner allowed a motive defence appeal in circumstances where 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 Special Commissioners, 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 (which will in turn be subject to tax under s.731 if the appeal is unsuccessful)? The answer must depend 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 taxable in principle under s.731.

19.47 Can an individual disclaim the motive defence?

An interesting question (which would have amazed 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 usually prefer to be taxed under s.731 than under s.87 TCGA, which may apply if s.731 does not.

(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. A would probably wish to disclaim the motive defence, if he could, so the capital payment to him was subject to income tax, and he avoided the CGT 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.

19.48 Transitional rules: pre-5 December 2005 transfers

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 ("new transactions") and the Old Conditions to pre-5 December 2005 transactions ("old transactions").

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 old transactions met the Old Conditions; but

(2) new transactions do not meet the New Conditions.

For the position where a post-4 December 2006 transaction meets the New Conditions, and a subsequent associated operation does not, see 19.42 (Transitional rules: post-4 December 2005 transactions).

19.48.1 *Transitional rule: s.730*

Section 740(4) ITA provides a transitional rule for section 730:

> 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.

The only effect of s.740(4) is that income before 5 December 2005 is not chargeable when a tainted associated operation takes place between 5 December 2005 and 5 April 2006.[156] Thus this provision was spent when the ITA took effect.

19.48.2 *Transitional rule: s.731*

Section 740(5) ITA provides a transitional rule for section 731:

> In determining the relevant income of an earlier tax year for the purposes of section 733(1) (see Step 4), 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.[157]

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 most remarkable position was actually intended: see EN FB 2006 para 33:

> Subsection (7) sets out Rule 2: for the purposes of section 740, 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.

156 See 19.42.1 (Income before associated operation: s.720).

157 There is no charge if the benefit is received in a tax year before the operation: see 19.42.2 (Income before associated operation: s.731).

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.

19.48.3 *Benefit received in or before 2005/06*

Section 740(6) ITA provides:

> For the purposes of Step 1 in section 733(1), a benefit received by the individual in or before the tax year 2005–06 is to be left out of account.

Section 740(7) ITA provides a transitional rule for benefits received in 2005/06:

> But, in the case of a benefit received in the tax year 2005–06, subsection (6) applies only so far as, on a time apportionment basis, the benefit fell to be enjoyed in any part of the year that fell before 5 December 2005.

This section was spent when the ITA took effect.

It is tentatively suggested that this applies only where a benefit accrues over time (such as an interest-free loan). If a benefit is actually received before 5 December 2005, it is not taxed. If the benefit is actually received on or after that date, it is fully within the scope of the new provisions.

19.49 Assessment of avoidance/mitigation distinction

For an assessment of subjectivity, morality and judicial criticism of the avoidance/evasion distinction see my article "Tax Avoidance Purpose and s.741 ICTA" [2004] BTR 375 at p.407.

CHAPTER TWENTY

NATIONAL INSURANCE CONTRIBUTIONS

20.1 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.

20.2 "Secondary Contributor"

Section 6(4) 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 general earnings, 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 general earnings 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 section 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]

20.3 "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 income tax under Schedule E;[4] and

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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.

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

(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".

20.4 The 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 regulations.

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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

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.

20.5 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.

20.5.1 *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 paragraph (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 paragraph (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 regulation 148, any earner by or in respect of whom contributions are or have been payable under sub-paragraph (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-paragraph (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.

20.6 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.

20.6.1 *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.

20.6.2 *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-paragraph (a) of paragraph (1) would apply, the conditions prescribed in that sub-paragraph and in sub-paragraph (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 paragraphs (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 33023:

> 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 regulation 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.

20.6.3 *Student exemption*

Reg. 145(3) SSCR provides an exception for students and apprentices:

> Where a person to whom paragraph (1)(a) would otherwise apply is not ordinarily resident in the United Kingdom and is not a person to whom the provisions of paragraph (2) apply, the proviso in paragraph (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.

20.6.4 *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.

20.7 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**

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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 …"

"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 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. [Paragraph 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
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
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.

20.8 ROW: Class 2 NIC

Reg. 145(1)(c)(d) SSCR provides 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.

20.9 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

---

13 These words omitted (presumably accidentally) from the SSCR but the context requires them.

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.

20.10 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.

20.11 Residence and ordinary residence

The NIC legislation does not define residence or ordinary residence. For residence, the NI Manual states at 29009:

> You should operate Residence Manual[15] guidance in deciding whether

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.

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 33032:

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.

20.12 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".

16 This is presumably a reference to the HMRC Residence Guide.

20.13 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:

> 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]

20.14 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;

20.14.1 *Place of employment rule*

Article 13(2) of Regulation 1408/71 provides a place of employment rule

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.

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 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.

20.14.2 *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

18 Residence is defined to mean habitual residence; Article 1(h).

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 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 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 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.

20.14.3 *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 Article 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.

19 Residence is defined to mean habitual residence: Article 1(h).

20.15 EEA: Self-employed rules

20.15.1 *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 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.

20.15.2 *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 Article 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

20 Residence is defined to mean habitual residence: Article 1(h).

> 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 Article 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 paragraphs (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 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.

20.16 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 TWENTY ONE

LIFE POLICIES AND CONTRACTS ("BONDS")

21.1 Introduction

This chapter considers:

(1) policies of life insurance,

(2) life annuity contracts, and

(3) capital redemption policies.[1]

These are together referred to as "a policy or contract". This is the terminology generally used in the legislation. The asset is often described in the insurance industry as a bond; statute has adopted that term in the

1 In practice, life insurance is the most common of the three.
The HMRC view on the meaning of the obscure expression "capital redemption policy" is contained in 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.

expression "personal portfolio bond". Strictly the term "bond" is wider, meaning any obligation undertaken by deed.

They fall within Chapter 9 Part 4 ITTOIA, known as the "chargeable event" regime. The subject needs a book to itself. The provisions are sometimes very crude. Partial surrender is a particular trap.[2] This is the only place I have seen in HMRC Manuals where districts are warned "not to attempt any discussion or explanation as to the equity of the treatment for tax".[3]

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 effectively opt into the chargeable event regime by choosing to invest in a policy rather than in some other form.

In outline, there are three stages to the application of the provisions. The first is to ascertain whether there is a "chargeable event". The second stage is to compute the gain arising[4] on the chargeable event. These aspects are not discussed here. The third stage is to ascertain the person chargeable.

It should be noted that no gain arises on an assignment for no consideration. This is the opposite of the CGT position.

21.2 Charge on individuals and"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.

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2 In practice this is avoided by life companies issuing a cluster of separate policies, instead of one single policy.

3 Assessment Procedures Manual, 3147a.

4 The general usage of the CGT legislation is that gains "accrue"; in the chargeable events legislation, gains "arise". There is no difference in meaning.

Condition A – gain charged on individual if he is beneficial owner – is natural and sensible.

There are two strange features about 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.[5]

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 only favour the taxpayer.

Condition C – gain charged on individual if held as security for the individual's debt – is an incredibly 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.

21.2.1 *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.

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 not UK domiciled and the gain arises

5 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 45.31 (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.

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) a UK resident foreign domiciled individual; or

(2) a trust with a UK resident foreign domiciled creator,[6]

unless the individual expects to be non-resident in the year of the chargeable event.

21.2.2 *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. It was formerly 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 CGT temporary non-residence rule does not apply; see 29.15 (Temporary non-residents).

21.2.3 *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:

> (1) The gain from a foreign policy of life insurance or foreign capital redemption policy is reduced for the purposes of this Chapter if the policy holder was not UK resident throughout the policy period.

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6 But it may be suitable if held by a non-resident company held by the trust: see below.

(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 (conditions A or C). It does not help individuals who have had non-resident periods but who are charged as creators of a trust (condition B). Section 529(1) 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,[7] or
> (c) by a foreign institution.

21.3 Charge on UK trust

If the creator of the trust is alive and UK resident, he will be taxed on the gain: see 21.2 (Charge on individuals). 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.
> (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—

7 It is clumsy and of course unnecessary to refer separately to trustee(s) in the singular and the plural; but it does not matter.

(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 or 466 above nor section 547(1)(b) of ICTA (circumstances in which a company is liable for tax under Chapter 2 of Part 13 of ICTA) 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.

21.4 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 charge in ICTA (which only applies to corporation tax).

In the absence of express provision, the gain arising from the policy would not fall within the TAA provisions because the receipt by the person abroad (assuming he is non-resident) is capital and not income.[8] However, s.468 ITTOIA deals with this. It is helpful to consider trusts and companies separately.

21.4.1 *Non-resident trusts*

Section 468 ITTOIA provides:

8 See 15.14 (Capital receipt deemed to be income).

468 Non-UK resident trustees and foreign institutions
(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. ...

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.[9]

21.4.2 *Non-resident company*

Section 468 ITTOIA provides (so far as relevant):

468 Non-UK resident trustees and foreign institutions
(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[10] beneficially owns *a share* in the rights,
  (ii) the rights are held for the purposes of a foreign institution, or
  (iii) *a share* in them is held as security for a foreign institution's debt.

(Emphases added) It is very curious that (i) and (iii) refer to *shares* in rights. Contrast ss.465(2) and 467(2) ITTOIA.[11] On a traditional approach to statutory construction the provision does not apply if the

9 It is similar to the overlap of s.624 ITTOIA and s.720 ITA.
10 Defined in s.468(5) ITTOIA: "In this Chapter 'foreign institution' means a company or other institution resident or domiciled outside the UK."
11 See 21.2 (Charge on individuals) and 21.3 (Charge on trusts).

foreign institution beneficially owns the *entire* policy. The gap is not filled in by s.468(1)(b)(ii) (right 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.

> (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 as it arises. The extensions of the scope of s.720 in 2005 catches those who I described in the 4th edition 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".

21.4.3 *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 they arose;[12] and

(2) the *transferor* receives a benefit.

A transferor is outside the scope of s.731: see 17.3 (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

12 See the 4th edition of this book, para.20.5.

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.

21.4.4 *Foreign domicile defence to s.731*

The s.720 foreign domicile defence will not apply to a gain within s.720, because the transferor would be chargeable on the gain if it had been received by him.

Suppose:

(1) a foreign company or trust within s.731 receives a gain; and

(2) a foreign domiciled beneficiary receives a benefit outside the UK.

The s.731 foreign domicile defence does not apply: the gain (which is deemed to be income for the purposes of s.731) is not "excluded relevant income", because the remittance basis does not apply to these gains. See 17.36 (Excluded relevant income).

21.5 Section 624 and life policies

Section 624 ITTOIA never applies to a gain arising on the disposal of a policy or contract. 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, section 624 has no application because the gain arising on the disposal of the life policy or contract 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.[13]

21.6 Planning for immigrant to UK

21.6.1 *Immigrant policyholder who has become resident in the UK*

The advisors 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 considered carefully.

An assignment of the policy or contract from an individual to a trust (resident or not) does not help, if the individual remains UK resident.

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.

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: see 21.4.2 (Non-resident company). An assignment for no consideration is not a chargeable event. 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; see 21.2.3 (Non-resident period relief).

Another possibility is that the trust holding the policy or contract is or becomes resident in an area with a suitable double tax treaty.

21.6.2 *Planning before becoming UK resident*

There are further possibilities if the individual acts before the tax year in

13 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 14.13 (Non-resident defence to s.648).

which he becomes UK resident. One possibility is to surrender the policies.

21.7 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, on which HMRC have issued 36 pages of Guidance Notes, cannot be pursued here.

21.8 CGT

Sections 204 and 210 TCGA provide exemptions for policies and contracts. In outline, policies are exempt unless assigned for consideration (known as secondhand policies).

21.9 Situs

On this topic see 46.18 (Policy situs for IHT); 47.15 (Policy situs for CGT).

21.10 IHT on UK situate policy

The IHT Manual provides:

> **IHTM30039 - Definition and extent of liability: policies effected by a person who dies domiciled outside the UK [June 2005]**
> Under the proviso to the [Revenue Act 1884][14] 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 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

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14 The Manual wrongly refers to the Customs & Inland Revenue Acts.

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

- 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
- it received prior notice that the policy in question is subject to a statutory charge for tax under IHTA s.237.

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 (IHTM01080) 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)

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 will not acquire or retain a UK situate policy.

CHAPTER TWENTY TWO

OFFSHORE FUNDS

22.1 Introduction

This subject needs a 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 ("OIG") arising on a disposal of a material interest in a non-qualifying offshore fund. In more detail, s.757(1) ICTA provides:

> (1) 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.

22.2 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 paragraph (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.

22.2.1 *"Collective investment scheme": general definition*

The definition is one of the most intricate in the tax code, and that is really saying something. 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 section 235 of that Act and orders made under subsection (5) of that section) or
> [b] would be 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.

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1 See 25.2.4 (Residence of unit trust trustees).

> (4) If arrangements provide for such pooling as is mentioned in subsection (3)(a) in relation to separate parts of the property, the arrangements are not to be regarded as constituting a single collective investment scheme unless the participants are entitled to exchange rights in one part for rights in another.

This is very wide, but there are very wide exceptions.

22.2.2 *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 Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 ("CIS Order 2001"). This sets out 21 categories of exceptions. Fortunately most of them are not relevant here.

22.2.3 *Exception for companies other than OEICs*

Para 21 of the Schedule to the CIS Order 2001 provides:

> 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 no other body corporate other than an open-ended investment company, amounts to a collective investment scheme.

22.2.4 *Definition of OEIC*

The definition of OEIC is crucial since all non-OEIC companies are excluded. Unfortunately the CIS Order 2001 fails to supply a definition! However HMRC assume (as the context perhaps 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.[2]

The printed words 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 for companies there are two different definitions of collective investment scheme:

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2 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.

(1) the FISMA definition ("FISMA CIS");

(2) the Offshore Fund definition ("Offshore Fund CIS"); but this is slightly narrower.

22.2.5 *FISMA definitions*

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:[3]

> ***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 section 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 section 756A ICTA was the same as the seven year period in section 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: ***The meaning of open-ended investment company: Frequently Asked Questions: Nos 4 and 8.***
> 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.

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3 Published on HMRC website on 17 May 2007; see *http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_027504*.

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:*
>
> *(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 <u>do</u> 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 section 756A together with 759 ICTA.

The HMRC argument is, to say the least, unconvincing and HMRC were right to change the law in 2007.

22.2.6 *Offshore fund definitions*

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 section 236 Financial Services and Markets Act 2000 ("FSMA"). ...
> Clause 56 achieves its aim by removing the reference to "reasonable period" in section 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 embarrassing irrelevance and waffle,[4] the statement continues:

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4 "The offshore funds regime applies only to an entity defined as a collective investment scheme within section 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 section 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.'"

> 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 section 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.

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 section 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 section 236 FSMA, as modified by clause 56 for the purposes of section 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 section 236 FSMA, as modified by clause 56 for the purposes of section 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 section 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 section 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 section 236 FSMA, as modified by clause 56 for the purposes of section 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.

22.3 Meaning of "non-qualifying" funds

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.[5] 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

5 For the requirements see HMRC Offshore Funds Guide.

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.[6]

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. 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 up funds". Hedge funds usually take this form.

22.4 Meaning of "material interest"

"Material interest" is a (not particularly apt) label for a disparate collection of rules.

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6 For this purpose "offshore fund" has a narrower definition: see s.756A(4) ICTA:

> "But the reference to offshore funds in section 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 section 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 section 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 the 5 per cent test in section 760(3)(a) ICTA."

22.4.1 *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[7] (whether by transfer, surrender or in any other manner).

I refer to this as the seven year test.

22.4.2 *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.

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7 "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

(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."

Insurance policies are excluded because they are covered by the chargeable events provisions.

22.4.3 *Offshore companies*

Offshore companies are not usually offshore funds because of the exception for companies other than OEICs.[8] There are two further exceptions, though these are not important after 1995. Section 759(8) ICTA provides:

> 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 wholly owned non-resident company is not an offshore fund because it is not a collective investment scheme. 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.

22.5 Meaning of "disposal"

In outline, the position is governed by section 757(2) ICTA:

> Subject to the following provisions of this section and section 758,

8 See 22.2.3 (Exception for companies other than OEICs)

> 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].

22.6 "Offshore income gains"

The legislation distinguishes:

(1) offshore income gains (the offshore funds concept); and

(2) chargeable gains (a CGT concept).

Offshore income gains are computed in accordance with Schedule 28 ICTA. There is no indexation relief, no taper relief and no tax free uplift on death. The OIG is therefore usually a greater amount than the chargeable gain accruing on the same disposal.

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.

22.7 OIG accruing to individual

Section 761 ICTA provides:

> **Charge to income tax or corporation tax of offshore income gain**
> (1) If a disposal to which this Chapter applies gives rise in accordance with section 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...

This refers to a "person" so it applies in principle to individuals and trustees.

22.7.1 *Non-resident individual*

Section 761(2) ICTA provides a territorial limitation for non-residents:

> Subject to subsection (3) below,
> [a] sections 2(1), 10 and 10B of the [TCGA] (persons chargeable to tax in respect of chargeable gains) and
> [b] section 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.

By implication, a person not resident (and not ordinarily resident) is not chargeable to IT on offshore income gains. This incorporates the CGT residence rules by reference.[9]

Suppose:

(1) An individual ceases to be UK resident.

(2) The individual disposes of an interest in an offshore fund.

(3) The individual becomes UK resident within five years of (1).

The CGT temporary non-residence rule does not apply to OIGs as such. So the gain is not an OIG. However, the gain accruing to a non-resident individual on the disposal of the interest in an offshore fund is a chargeable gain. So the gain may be subject to CGT under the CGT temporary non-residence rules.

22.7.2 *UK resident foreign domiciled individual*

Section 761(5) ICTA provides a remittance basis for the UK resident

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9 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.

foreign domiciled individual:

> In the case of individuals resident or ordinarily resident but not domiciled in the UK, section 12 [TCGA] (which provides for taxation on a remittance basis) shall have effect in relation to income tax chargeable by virtue of subsection (1) above on an offshore income gain as it has effect in relation to capital gains tax in respect of gains accruing to such individuals from the disposal of assets situated outside the UK.

Amended as s.761(5) directs, s.12 TCGA provides:

> **Foreign assets of person with foreign domicile**
> (1) In the case of individuals resident or ordinarily resident but not domiciled in the UK, [income tax] shall not be charged in respect of [offshore income gains] accruing to them from the disposal of assets situated outside the UK ... except that the tax shall be charged on the amounts (if any) received in the UK in respect of those [offshore income gains], any such amounts being treated as gains accruing when they are received in the UK.

This incorporates the CGT remittance basis by reference.[10] It is theoretically possible that an offshore fund may be a UK situate asset (the CGT situs rules apply) 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.

22.8 OIG accruing to UK trust

22.8.1 *UK resident trust*

A UK resident trust is in principle subject to tax on offshore income gains. Tax is charged at the trust rate, 40%: s.482 ITA.

22.8.2 *UK resident settlor-interested trust*

The OIG accruing to UK trustees is not "income" in the general (trust law)

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10 See 29.2 (CGT remittance basis).

sense but since it is "treated for all the purposes of the Tax Acts as income" it will fall within s.624 ITTOIA. 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).

What if the settlor is not UK domiciled and the OIG is not remitted? The OIG then falls within s.624 foreign domicile defence.[11] It follows that the OIG is then chargeable on the trustees after all.

22.9 OIG accruing to non-resident trust

Where an OIG accrues to a non-resident trust, the trustees are not subject to tax on that gain. This is for two reasons either of which would be sufficient: s.761(2) imposes a territorial limitation and s.761(7) (set out below) disapplies the charge altogether. However, s.87 TCGA and ss.720, 731 ITA apply, with refinements just for the OIG rules. The result is exquisite complexity.

22.9.1 *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:

> 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 paragraph (a) above the trustees of the settlement are neither resident nor ordinarily resident in the 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.

22.9.2 *Transfer of assets abroad provisions*

Section 762(5) ICTA provides:

11 See 14.6 (s.624 foreign domicile defence).

> Subject to subsection (6) below,[12] for the purpose of determining whether an individual ordinarily resident in the UK has a liability for income tax in respect of an offshore income gain which arises on a disposal to which this Chapter applies where the disposal is made by a person resident or domiciled outside the UK—
>
> (a) Chapter 2 of Part 13 of ITA 2007 (transfer of assets abroad) shall apply as if the offshore income gain arising to the person resident or domiciled outside the UK constituted income becoming payable to him, and
>
> (b) any reference in that Chapter to income of (or payable or arising to) such a person accordingly includes a reference to the offshore income gain arising to him by reason of the disposal to which this Chapter applies.

If the transferor is not UK domiciled, the s.720 foreign domicile defence will apply, provided the OIG is received offshore.

The application of s.731 ITA is wider than the s.87 OIG charge because the s.731 foreign domicile defence is more limited.

22.9.3 *Section 87 TCGA*

Section 762(2) ICTA incorporates the s.87 TCGA rules[13] but with amendments:

> Subject to subsections (3) and (4) below, sections 87 to 90 and 96 to 98 of the [TCGA] (gains of non-resident settlements) shall have effect in relation to offshore income gains subject to the following modifications ...

Amended as s.762 directs, s.87 TCGA reads (so far as relevant):

> **Attribution of gains to beneficiaries**
>
> (1) This section applies to a settlement for any year of assessment during which the trustees are at no time resident and ordinarily resident in the UK.
>
> (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

12 See 22.9.5 (OIG distribution defence).

13 See 30.6 (The s.87 charge).

> been chargeable to [income tax by virtue of section 761 ICTA] if they had been resident and ordinarily resident in the UK 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 [offshore income 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...
> (4) Subject to the following provisions of this section, the trust gains for a year of assessment shall be treated as [offshore income 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 [offshore income 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 [including offshore income gains] have by reason of the payment been treated as accruing to the recipient in an earlier year.
> (7) A beneficiary shall not be charged to [income tax or corporation tax] on [offshore income gains] treated by virtue of subsection (4) above as accruing to him in any year unless he is domiciled in the UK at some time in that year...

It is necessary to distinguish the CGT s.87 rules and the OIG s.87 rules: the rules are similar but not identical. I refer below to:

(1) the CGT s.87 charge (applying to CGT trust gains)

(2) the OIG s.87 charge (applying to OIG trust gains).

The OIG s.87 charge does not directly concern a non-resident beneficiary, because a non-resident is not chargeable to income tax. The temporary non-residence rule does not apply. The OIG s.87 charge does not directly concern a foreign domiciled beneficiary because s.87(7) provides a complete defence. But other beneficiaries are affected because payments to non-resident or foreign domiciled beneficiaries can "wash" OIG trust gains, as they can other gains.

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 ("matching") rules in ss.91–95 TCGA apply to

CGT trust gains but not to OIG trust gains.

22.9.4 *Trust with CGT trust gains & OIG trust gains*

Section 762(4) ICTA deals with a trust which has CGT trust gains and OIG trust gains:

> If, in any year of assessment—
> (a) under subsection (3) of section 87 of the [TCGA], as it applies apart from subsection (2) above, a chargeable gain falls to be attributed to a beneficiary, and
> (b) under that subsection, as applied by subsection (2) above, an offshore income gain also falls to be attributed to him,
> subsection (4) of that section (gains attributed in proportion to capital payments received) shall have effect as if it required offshore income gains to be attributed before chargeable gains.

That is, the OIG s.87 charge has priority to the CGT s.87 charge. This is helpful because it facilitates operation of the OIG distribution defence. It also helps to defer the interest supplement (matching) rules.

22.9.5 *OIG distribution defence to ss.720, 731 ITA*

Section 762(6) ICTA provides:

> To the extent that an offshore income gain is treated, by virtue of
> [a] subsection (1)[14] or
> [b] subsection (2)[15] above,
> as having accrued 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 Chapter 2 of Part 13 of ITA 2007 or any provision of Chapter 5 of Part 5 ITTOIA.

I refer to this as "the OIG distribution defence". The important point here is that an OIG may be treated as *accruing* to a UK resident non-domiciled beneficiary even though he is not charged to tax on that OIG. Thus the OIG distribution defence offers a defence to s.720/731 without any tax

14 This relates to OIGs accruing to companies within s.13 TCGA.
15 This relates to the OIG s.87 charge: see 22.9.3 (s.87 TCGA).

charge. It is pleasing to note that the unprincipled extension of s.87 TCGA in 1998 had the effect of increasing the scope of the OIG distribution defence.

Suppose:

(1) a non-resident trust within s.731.

(2) the trust receives an OIG.

If a capital payment is made to a UK resident beneficiary:

(1) the beneficiary is subject to tax under the OIG s.87 charge if UK domiciled but not if non-domiciled.

(2) the relevant income is reduced by the capital payment (even if the beneficiary is not UK domiciled).

A trust within s.731 with UK resident foreign domiciled beneficiaries may do better to invest in non-qualifying offshore funds (outside the scope of s.731) rather than distributor funds (which produce relevant income for s.731 purposes).

Suppose:

(1) a non-resident trust within s.720;

(2) the trust receives an OIG. The settlor/transferor is taxed (unless the foreign domicile s.720 defence applies).

The settlor/transferor likewise escapes the charge if capital payments are made to UK resident beneficiaries.

When must the distribution be made? One view is that the distribution must be made in the same year, for IT is an annual tax. But then an OIG realised on 5 April would have to be distributed the same day, which is odd. It is suggested that distribution may be at any time before an assessment becomes final.

22.9.6 *Capital payment to non-resident beneficiary*

What about a capital payment to a non-resident beneficiary? This does not qualify for the OIG distribution defence. However, such a payment will:

(1) reduce OIG gains and CGT trust gains (under ordinary principles), and

(2) reduce OIG or other relevant income if made out of that income.

22.10 OIG accruing to company owned directly by individual

Section 762(1) ICTA incorporates s.13 TCGA with modifications. Amended as s.762 directs, s.13 TCGA reads:

> **Attribution of gains 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, who, if an individual, is domiciled in the UK, and who is a participator[16] 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.

Thus if the individual is not domiciled, the gain accruing to the company is outside s.13 ITA. The gain is within s.720 (subject to the s.720 foreign domicile defence).

The gain is within s.731 ITA, subject to the rather less generous s.731 foreign domicile defence. The OIG distribution defence does not apply here as the OIG is not treated as having accrued to the foreign domiciled shareholder; contrast the position for trusts set out above.

16 Section 13(12) 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).

22.11 OIG accruing to company held by non-resident trust

The OIG is attributed to the trustees as s.762(1) incorporates s.13(10) subject to modifications. Amended as s.762(1) directs, s.13(10) reads:

> 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, … if when the gain accrues to the company the trustees are neither resident nor ordinarily resident in the UK.

The position is then as set out in paragraph 22.9 (OIG accruing to non-resident trust) above.

22.12 Application of remittance basis to Irish offshore funds

A UK resident foreign domiciled individual is taxed:

(1) on Irish source income, on an arising basis;

(2) on Irish situate capital gains, on a remittance basis.

Since the offshore fund rule incorporates the CGT rules, an Irish source OIG of an individual is taxed on a remittance basis.

What about an Irish source offshore income gain of a non-resident trust or company in which the settlor is interested, if the settlor is resident and not UK domiciled? The OIG qualifies for the s.720 foreign domicile defence. The defence applies the counterfactual test of whether the settlor would be taxable if he had in fact received the income. See 16.14 (Foreign domicile defence). It follows that the defence incorporates the CGT remittance basis. Irish source OIGs fall within this defence.

22.13 Interaction with CGT

A disposal for the offshore funds rules is generally also a disposal for CGT. Section 763 ICTA gives relief against a double charge:

> **Deduction of offshore income gain in determining capital gain**
> (1) 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".
> (2) 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 section 37(1) of that Act (deduction of consideration chargeable to tax on income).

The relief applies if the OIG arises on a "material disposal". (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".) "Material disposal" is defined in para 1 Sch 28 ICTA:

> In this Part of this Schedule "material disposal" means a disposal to which [this Chapter][17] applies, otherwise than by virtue of section 758.

The exception in s.758 concerns equalisation arrangements, not discussed here. Section 763(3) 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 an offshore fund will not normally give rise to a chargeable gain.

22.14 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.[18] The

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17 "This Chapter" is obviously 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.

18 Section 152(8) ITA.

loss will be allowable for CGT if ordinary CGT principles permit;[19] in practice this means that foreign domiciled individuals and non-residents have no loss relief; see 29.18 (Capital losses). The loss is computed on CGT principles (not in accordance with the OIG computation rules of Schedule 28 ICTA).

22.15 Commentary: let's abolish offshore funds

The case for the repeal of the offshore funds code is very strong. It was introduced in 1984 to stop income tax avoidance at a time when the top rate of IT was 60% and CGT was charged at 30%. Now the rates have (more or less) been aligned, the rules should be repealed. The only significant tax advantage is CGT taper relief, so repeal offers the opportunity for considerable simplification at a modest tax cost. Indeed there may be no tax cost at all, because abolition would bring offshore funds into the interest supplement (matching) rules, the absence of which allows more tax planning for offshore income gains than for CGT.

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19 Inspectors Manual 4107 (October 2003) provides:

> "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, 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.

CHAPTER TWENTY THREE

ACCRUED INCOME PROFITS

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] Reform was promised in 2006 but radical change has been rejected and the matter now seems to have dropped.

The following focuses on the questions which most affect foreign domiciliaries and non-residents. The SII Manual has some useful material which is not set out here.

The provisions apply on a transfer of securities.

23.1 AIP securities

The definition is in s.619 ITA:

> (1) 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),
>
> but (subject to paragraph (b)) it does not include any shares in a company.
> (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,

1 Responses to Consultation Exercise on Reform of the AIP, Inland Revenue, December 2004.

(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.

Excluded securities are defined in s.619(3) 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.

23.2 "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 paragraph (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.

23.3 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.

Likewise s.624(1) ITA:

> 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).

In practice it is impractical for fund managers to dispose of securities on the interest payment date, and securities tend to be disposed of with or without a little accrued interest.

23.4 Deemed payments

Section 632(1) ITA provides for a deemed payment:

> **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.

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—

$$I \times \frac{A}{B}$$

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.

Section 633 ITA contains corresponding rules on a transfer without accrued interest.

23.5 Accrued income profits and losses

"Accrued income profits" and "accrued income losses" are defined in s.628 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).

23.6 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 AIP charge:

616 Charge to tax on accrued income profits

Income tax is charged on accrued income profits.

23.6.1 *Relief for losses*

Section 679 ITA confers loss relief:

(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.

23.7 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.

Thus an excluded person is broadly outside the AIP scheme.

23.8 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. 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.

23.9 AIP foreign domicile defence

Section 644 ITA provides:

> **Individuals to whom the remittance basis applies**
> (1) This section applies if—

(a) there is a transfer of securities by or to an individual in a tax year, and
(b) interest on the securities in respect of which the individual is liable to income tax for the tax year—
  (i) is charged in accordance with section 832 of ITTOIA 2005 (relevant foreign income charged on the remittance basis), or
  (ii) would be so charged if there were any.

(2) The individual is an excluded transferor in relation to the transfer if it is made by the individual.
(3) The individual is an excluded transferee in relation to the transfer if it is made to the individual.

I refer to securities whose interest is taxed on the RFI remittance basis as "foreign securities".

This is a complete exemption: the AIP income is not taxed even if the proceeds of the securities are received in the UK. The Inspectors Manual para.4253 (October 2003) provides:

> **Foreign securities to which the remittance basis applies**
> Sub-sections (1)(j) and (2)(b) exclude individuals from the Accrued Income Scheme as regards transfers of foreign securities in circumstances where, if interest arose on the securities, any tax liability on the interest under Case IV or V Schedule D would be computed on the remittance basis rather than the normal arising basis – see ICTA Section 65(4) and IM1560.

This accepts the position as set out above. At first sight that seems surprising, but it is probably deliberate. One could not fairly impose a charge in this situation without also allowing corresponding AIP relief, and the scheme of the Act is to disallow that relief. (It is also difficult to apply a remittance basis, because one cannot easily identify what asset represents the AIP income, though this is not an insuperable objection.)

A foreign domiciliary can in principle avoid the ordinary IT charge on remitted interest by selling foreign securities before the interest payment date. But this is not of practical importance since:

(1) A foreign domiciliary can also avoid the charge on remitted interest by source-ceasing, which is usually an easier course.

(2) CGT may fill the gap left by the AIP foreign domicile defence. The

gain on the disposal may be subject to CGT on the remittance basis, if the proceeds of the disposal are received here.

Since the exemption withholds AIP relief,[2] a foreign domiciliary who purchases foreign AIP securities with accrued interest, and receives and remits the interest without source-ceasing, will pay more income tax than a UK domiciliary.

23.10 Settlor-interested trusts

Section 667(1) ITA deals with UK resident trusts:

> **Trustees' accrued income profits treated as settlement income**
> (1) If the trustees[3] of a settlement are treated as making qualifying accrued income profits,[4] 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).
> (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 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

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2 The individual could obtain AIP relief by not claiming remittance basis treatment in a year, if he is willing to forgo the remittance basis on RFI income. See 9.9 (Claims).

3 Defined in s.667(4)(b) ITA.

4 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.

s.624 ITTOIA. This applies to resident and non-resident trusts. However, the s.624 foreign domicile defence can apply and will provide a complete defence: the s.648 clawback will not apply.

UK resident trustees qualify for AIP loss relief. Non-resident trustees would not qualify, but 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.

23.11 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 he is non-resident). However, s.747 ITA deals with this:

> (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 only applies 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.[5] 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 ...").

Section 747(4)(5) provides corresponding relief for AIP losses:

> (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
> (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.

23.11.1 *Section 731 ITA*

Suppose a person abroad is treated as receiving AIP income. The amount is certainly "income" for tax purposes, but the better view is that it is not "relevant income". The AIP income is fictional so one cannot say that it "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.[6]

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5 See s.710(1A) ICTA.

6 The same point arises for stock dividends; see 17.11 (Stock dividend).

HMRC may argue that one should carry through the deeming:[7] 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). But there are great difficulties in this:

(1) The CGT relief in s.119 TCGA 1992 would seem to apply (whether or not any charge under s.731 ever arises) giving a settlor within s.86 TCGA 1992 an anomalous advantage.

(2) How would the rule that distributed income is not relevant income[8] operate in this context? Would it be necessary merely to distribute the AIP income or 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.[9] Then the only way to avoid relevant income by distribution would be to distribute the entire proceeds of the transfer. One difficulty with this view is that it does not explain how to deal with AIP relief. This tends to support the view that deemed AIP income is outside the scope of s.731.

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7 For the general approach to deeming provisions, see 35.12.1 (Construction of deeming provisions).

8 See 17.18 to 17.22 (Distributed income).

9 See 24.10.1 (Section 731 ITA).

CHAPTER TWENTY FOUR

DEEPLY DISCOUNTED SECURITIES

24.1 Introduction

This subject needs a book to itself. The following focuses on the questions which most affect foreign domiciliaries and non-residents. The Inspectors 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").

24.2 Meaning of "deeply discounted security"

24.2.1 *"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.

ITTOIA EN Vol II explains:

295. A security is capable of yielding a "deep discount" if the amount payable on redemption could exceed the issue price by more than a specified percentage of the amount payable on redemption. In the rare case where the security has an expected life of 30 years or more, the percentage specified is 15%. In all other cases the percentage specified is equal to half the number of years between the date of issue and the date of redemption.
296. This means that a deep discount occurs where the amount payable on redemption could exceed the issue price and the potential difference amounts to more than 0.5% of the amount payable on redemption for each year of the security's life. For example, a five year bond issued for £90 and redeemable for £100 is a deeply discounted security because the discount is more than the specified 2.5% (that is, 0.5% for each year of the bond's life). This is expressed in subsection (1) by means of a formula.

24.2.2 *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.

(2) An excluded indexed security (see section 433) is only a deeply discounted security if treated as such under section 431(5) (acquisition by a person connected with the issuer or holder becoming such a person).
(3) In this section "capital redemption policies" has the same meaning as in Chapter 9 of this Part (see section 473(2)).
(4) See also sections 434 to 436 (rules under which securities issued under the same prospectus on separate occasions may be treated as being, or as not being, deeply discounted securities).

24.3 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 paragraph (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.

24.4 Meaning of "profit"

Section 439 ITTOIA provides:

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.

Section 440 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 this as the market value rule.

24.5 The charge to tax

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.

24.6 DDS foreign domicile defence

Section 428(3) ITTOIA brings in the RFI 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).

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 provides:

> 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 know where we stand.[1] The source-ceasing rule does not apply.

24.7 UK resident trustees

Section 457 ITTOIA provides:

> **457 Trustees**
> (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.
> (3) For the purposes of Chapter 1C of Part 15 of ICTA (settlements: liability of trustees), the profits are to be taken to be income arising to the trustees.

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%.

24.8 Non resident trusts: 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 and they are non-UK resident.

Non-resident trusts are not subject to tax on securities, whether UK or foreign. However, s.624 will still apply to non-resident settlor-interested

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1 The position if the issuer changes residence is less clear, but in practice perhaps this does not arise.

trusts.

24.9 Non-resident individuals or companies

There are no express provisions for non-resident individuals or companies, so they are chargeable if the security is in the UK and not chargeable if the security is out of the UK.

24.10 Transfers of assets abroad

Section 459 ITTOIA provides:

> **459 Transfer of assets abroad**
> (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.

24.10.1 *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[2] 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 issue which arises when a UK resident foreign domiciled beneficiary sells a non-UK situate asset and realises a chargeable gain. Tax is charged on the amounts received in the UK in respect of the gain. If the individual remits (say) one-half of the proceeds of sale, he is regarded as remitting one-half

2 See 17.18 to 17.22 (Distributed income).

of the gain. This is the HMRC view, which is generally accepted as correct.[3]

Inspectors Manual paragraph 1567 explains:

> 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[4] then s.731 does not apply because fictional income cannot be used to benefit a beneficiary, so it cannot be relevant income.

3 See 29.5 (Remittance of gain or base cost?).

4 See 24.4 (Meaning of profit).

CHAPTER TWENTY FIVE

OFFSHORE UNIT TRUSTS

25.1 Definition(s) of "unit trust"

In *CPT Custodian Pty Ltd. v State Revenue,* 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 many 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 (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 22.2.1 (Meaning of "collective investment scheme"). A wide variety of arrangements may be unit trusts.

25.2 Income accruing to unit trust

25.2.1 *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.

25.2.2 *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.

25.2.3 *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. 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 8.18 (Income from IP 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]

Where a UK resident foreign domiciled individual invests in an unauthorised Irish unit trust:

(1) The income will be taxable on the remittance basis if the underlying investments are not Irish (and not UK) source and it is a *Baker* style trust.

(2) The income is by statute taxable on an arising basis if the trust is a *Garland* style trust.[4]

Where the individual acquires units in a unit trust in any jurisdiction apart from the UK or Ireland:

(1) If the unit trust is a *Baker* trust, income is taxed on a remittance basis except so far as the income comes from underlying assets which are UK source or (by statute) Irish source.

(2) If the unit trust is a *Garland* trust, income is taxed on a remittance basis regardless of source, with credit for UK and foreign tax under the *Garland* concession, if this is applied.

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

3 The same point is made at 4C.401.

4 It would be within the spirit of the *Garland* concession not to take this point; see 8.18.5 (The Garland concession).

> 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 1617 provides:

> **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[5] whether [1] this is paid out to him in cash or [2] used to purchase additional units.

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.

5 This assumes the unit trust is a non-transparent *Garland* style trust; or else that it only holds foreign investments.

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.

25.2.4 *Residence of trustees of unit trust*

There is no definition of residence for IT purposes. The IT definition of residence of “trustees of a settlement”[6] does not apply, because a unit trust is not a “settlement”.[7] Ordinary rules of residence apply to determine the residence of the trustees in their private capacities.

25.3 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.

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6 See 5.1 (Residence of trustees).

7 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).

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). Since a unit trust is treated as a company, it is considered that the test of residence for CGT is the corporate test, ie, central management & control.

Gains accruing to a non-resident quasi-close unit trust fall in principle within the scope of s.13 TCGA 1992, and may be attributed to UK resident and domiciled unit holders.[8]

25.4 Situs of unit for IHT

The situs of a unit in an authorised unit trust is not normally relevant for IHT.[9] 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.[10] One should not apply rules governing other kinds of equitable interests without considering this.

It is suggested that share/security situs rules should normally be applied, so that the place of the register is normally the determining factor. HMRC accept this.[11]

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 so rare that 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

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8 Julian Ghosh QC agrees: "When is a company not a company" PTPR Vol 7 p. 241.

9 See 33.4 (Authorised unit trusts and OEICs).

10 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.

11 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).

for IT and CGT purposes.[12] 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 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.[13]

(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 holder of a unit 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.

25.5 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[14] and the unit is deemed to be a share. This is the same as the common law (and

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12 See 22.2 (Meaning of "offshore fund") and 25.2.2 (UK unauthorised unit trusts).

13 A similar argument applies in relation to the situs of an equitable interest under a substantive trust.

14 See 47.4 (Registered shares).

IHT) situs rule for units in a unit trust.

If the unit trust is governed by a UK proper law, it is probably deemed UK situate under the UK law rule,[15] but since a UK law unit trust in practice will have a register here, 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]

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]

25.6 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.

25.7 IHT treatment of unit

For authorised unit trusts, see 33.4 (Authorised unit trusts & OEICs).

15 See 47.11.2 (The UK law rule).
16 See 47.13 (Co-ownership).
17 See s.99(5A) FA 1986.
18 See 22.1 (Offshore funds).

CHAPTER TWENTY SIX

WITHHOLDING TAX ON INTEREST

26.1 Introduction

This chapter considers when tax must be deducted at source from the payment of interest. This topic is important to foreign domiciliaries and non-residents since they (or connected trusts) often take out loans on which tax may be deductible from the interest. This book only considers interest paid by individuals, trustees and PRs (not companies).

26.2 Obligation to deduct

Section 874 ITA is a considerable improvement on its clumsily worded predecessor in ICTA. It 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 savings rate in force for the tax year in which it is made.

So far as individuals, trustees and PRs are concerned, the obligation therefore arises 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.

26.3 To whom is interest paid?

In the following discussion a person whose usual place of abode is in the UK is described (for brevity) as "in the UK". 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.

Suppose:

(1) interest is paid to a transparent (*Baker* style) interest in possession trust which is not a settlor-interested trust; and

(2) the trustees are in the UK but the life tenant is not.

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 not in 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 not in the UK, there is an obligation to deduct even if the trustees are in the UK. It is tentatively suggested that that is the correct view. But this result is surprising: the payer is expected to know whether the payee is in 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 in 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.

26.4 Usual place of abode

The Property Income Manual 4800 [February 2007] discusses this expression in the context of the non-resident landlord legislation. It is considered that the expression has the same meaning here:[1]

> **Meaning of 'usual place of abode'**
> '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.
>
> 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 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].)[2]

1 This is supported by ITB EN para 2648: "The term 'usual place of abode' is consciously retained *because it is a technical term* distinct from residence" (emphasis added).

2 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.

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.

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.
c. Trustees have a usual place of abode outside the UK if all the trustees have a usual place of abode outside the UK.

Point c. was written before the statutory trustee residence rules, and it is considered that the usual place of abode for trustees is where they are resident under those rules.
It is suggested that the law could and should be simplified by replacing the reference to a UK place of abode with a reference to residence. But in practice it more or less comes to the same thing.

26.5 Exceptions to obligation to deduct

26.5.1 *Foreign source interest*

Section 884 ITA provides:

> **Relevant foreign income**
> (1) 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.
> (2) For the meaning of "relevant foreign income", see section 989.

This is otiose, as the obligation only applies to interest arising in the UK.[3]

26.5.2 *Interest paid to UK bank*

Section 879 ITA provides:

> **Interest paid on advances from banks**
> (1) The duty to deduct a sum representing income tax under section 874

3 See 8.16 (Situs of source of interest).

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.[4]

26.5.3 *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 exemption 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

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4 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).

> therein shall, subject to the following provisions of these regulations, be paid as directed in the notice...

For the procedure see RI 79, Tax Bulletin 41, CNR Guidance Note No. 1 07/02 (Applications for Relief at Source on Interest Payments where both Lender and Borrower are outside the UK) and the HMRC booklet "Double Taxation Relief Provisional Treaty Relief Scheme".

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 Switzerland[5] and Ireland.[6]

The Jersey, Guernsey and Isle of Man DTTs do not provide an exemption for interest. They do however provide exemption for business profits. The Jersey DTT is typical:

> 3. (2) 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 enables the payer of the interest to pay the interest gross provided:

(1) A suitable claim has been made and agreed by HMRC.

(2) The recipient is a "Jersey Enterprise" as defined (e.g. a Jersey Bank) and is not engaged in trade or business in the UK through a permanent establishment situated here.

An exemption for business profits must exempt the component parts of the profits. Could HMRC argue that the interest is not "industrial or commercial profits" of the Jersey enterprise, it is merely an item in computing what the industrial or commercial profits are? This is far too

5 UK/Switzerland DTT Art. 11.
6 UK/Ireland DTT Art. 12.

narrow a view.[7] HMRC appear to accept this in practice.

26.5.4 *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. It is not practical to rely on this except for very short term loans.

26.5.5 *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 tax as interest.

Inspectors Manual 1548 rightly provides:

> **Relevant discounted securities: Deduction of tax**
> [October 2003]
> Discounts or premiums payable on the redemption of relevant discounted securities[8] are not payments of interest. Consequently the payments are made without deduction of tax.

However, the distinction between interest and discounts/premiums can be

---

7 The point arose in reverse in *Hughes v Bank of New Zealand* 21 TC 472. Here the bank received interest which was part of its trading profits. There was an exemption for the interest. HMRC sought to bypass the exemption by charging the taxpayer on its trading profits. The House of Lords held that the exemption applied "to the interest in question, whether as interest or as a component part of the profits of the trade".

8 Discounts and premiums on securities which are not "relevant discounted securities" are also not "interest".

fraught.

26.6 EU Interest & 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 (which applies to EU states). I refer to this as "the Directive".

(2) International agreements made by individual tax havens.[9]

(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).[10]

(4) Guidance notes issued by each state.[11]

A full discussion requires many volumes to itself.

In the following discussion, "an ISD state" is a state where the Directive applies.

In short, the rules apply when a "paying agent"[12] established in one ISD state pays "interest"[13] to an individual who is "resident"[14] 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:

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9 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.

10 In the UK this has been done by the Reporting of Savings Income Information Regs 2003 SI 3297.

11 In the UK see *www.hmrc.gov.uk/esd-guidance/guidance.htm*. But UK resident foreign domiciliaries would not be concerned about UK EST law.

12 This term is elaborately defined: Directive Article 4. It includes trustees but not (in short) individual borrowers not carrying on business.

13 This term is also elaborately defined: art.6.

14 This term is defined in art.3(3).

(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[15] in such a jurisdiction pay interest to a life tenant resident in the UK.

The paying agent has one of 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.[16]

Many jurisdictions take the view that the withholding/disclosure requirement does not apply when a payment of interest is made to a UK resident foreign domiciled individual, if the interest is not remitted (and so not subject to UK tax).[17] This is a purposive construction, as the point

---

15 Payment from a discretionary trust or non-transparent IP trust is not "interest" and so it does not require withholding or disclosure. No doubt the Directive will eventually be extended to cover this.

16 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.

17 The Channel Islands and the Isle of Man take this view. See e.g. paragraph 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);

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 the foreign domestic law, and international law, but not on any view questions of UK law.

In practice, if the paying agent, guided no doubt by the local authorities, take the view that the duty of withholding/disclosure applies 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.

26.6.1 *Credit for withholding tax*

If tax is withheld, 75% of it is paid to the Member State where the beneficiary is resident.[18] But the beneficiary is entitled to a tax credit for 100% of the tax withheld.[19]

HMRC now accept that the credit is applicable even to unremitted income taxed on the remittance basis. The Notes on foreign pages for 2005/06 provided:

> If you have claimed for your foreign income to be taxed on the remittance basis then you can only claim [to offset against UK tax] the Special Withholding Tax that relates to the income remitted during this year.
>
> **Example 3**
>
> Adam received interest of £1,000 from Jersey. Special Withholding Tax (SWT) of £150 was withheld. Adam is non-domiciled in the UK so claims for his

---

…

- 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 accessible *www.estv.admin.ch/d/euz/docs/euz-wegleitung-20070315-d.pdf.*

18 Art.12.

19 Art.14.

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

...

If Capital Gains Tax is payable by reference to the amount of the gain received in the UK then you can only claim [to offset against UK tax] the Special Withholding Tax that relates to part of the gain that has been brought into the UK.

Example 9

Lucy is non-domiciled in the UK. She sold some shares in an Austrian company resulting in a gain of £20,000. £3,000 tax was withheld by Austria. Half of the net proceeds (£8,500) was brought into the UK. The Special Withholding Tax that relates to the £8,500 is £3,000 x 8500/17000 = £1,500.

But HMRC changed their mind in Tax Bulletin 84:

> There is an error in the notes and examples at page FN3 (Example 3) and FN15 (Example 9) of the Notes on Foreign pages.
> This affects UK resident individuals receiving payments that have been subjected to Special Withholding Tax (SWT) described on page FN3. But who are making their return in respect of those payments by reference to amounts received in the UK in respect of the income or gain (the remittance basis).
> In Example 3, under the heading "Foreign Income taxed on the remittance basis" on page FN3, the final line should indicate that the full amount of SWT (that is £150 in the example) should be entered on the return at column D. The remainder of the example is correct. The opening sentence above the example should read:
> "If you have claimed for your foreign income to be taxed on the remittance basis you can still claim the Special Withholding Tax that relates to the income arising during this year".
> Similarly in Example 9, under the heading "Relief for Special Withholding Tax paid on gains" on page FN15, the final sentence should indicate that the full amount of SWT (that is £3,000 in the example) should be entered on the return at box 6.10A. The final sentence of the paragraph above the example should read:
> "If Capital Gains Tax is payable by reference to the amount of the gain received in the UK you can still claim the Special Withholding Tax that relates to the whole gain that has accrued in the year".

If a credit is given against tax, the amount credited is not received in the UK and so not remitted. If the credit takes the form of a refund, received in the UK, it is considered that the amount received is "in respect of" the foreign interest, and so is regarded as remitted.

But if countries adopt the view that no withholding applies to unremitted income, this issue will not arise.

CHAPTER TWENTY SEVEN

LOANS FROM NON-RESIDENT COMPANIES

27.1 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 ss.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.[5] The liability to repay the loan may not be deductible for IHT purposes.[6]

I assume that the company is not UK resident when the loan is made.

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1 See 17.4.4 (Interest-free loan).
2 See 16.12 (Transferor receives capital sum).
3 See 14.21 (Settlor receives capital sum).
4 See 14.6 (s.624 foreign domicile defence); 16.14 (s.720 foreign domicile defence); 17.33 (s.731 foreign domicile defence).
5 See 9.37 (Circular transactions returning income to taxpayer).
6 See 37.1 (IHT deduction for debts).

Loans *to* non-resident companies raise different issues, not discussed here.

27.2 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 in a trust, the question whether the trustees can properly permit the loan to be made needs to be reviewed.

27.3 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.

27.4 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".

27.5 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[7] (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.

The BIK earnings of an employment-related loan may be chargeable overseas earnings. If so, it is considered that they cannot be remitted so no tax charge can arise.[8]

27.5.1 *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.[9] In relation to interest-free loans from offshore companies, the same technical point arises. However in this case HMRC do not so often 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. In fact 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 one possible explanation. But it is unsafe to plan on that basis. (This is yet another example of the practical difficulties arising from the unprincipled decision in *R v Dimsey and Allen*.)

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7 See 42.10 (Shadow directors: HMRC practice); 42.18 (Who is a shadow director?).

8 See 42.24 (BIK remittance basis). If that is wrong, imponderable questions arise as to what happens if the money lent is remitted here and spent. Contrast 17.34.1 (Interest-free loan and s.731 foreign domicile defence).

9 See 42.10 (Shadow directors: HMRC practice).

27.6 Meaning of "employment-related loan"

27.6.1 *"Loan"*

Section 173(2)(a) ITEPA provides:

> "loan" includes any form of credit,

EIM para.26108 provides:

> **26108. Meaning of loan**
> 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.

27.6.2 *"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 summarises this and then provides:

> So, if a company pays money into a trust fund, and the trustees then make loans to employees, the loans can be treated as if they were made by the company. The company has "in any way" facilitated the loans to the employees.

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.

27.6.3 *Person making the loan*

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.

27.6.4 *"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[10] or a relative[11] 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[12] 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, 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.

---

10 For the definition of "employee" see 42.8.3 ("employee").

11 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 paragraph (b) or (c).

12 "Material interest" is defined in s.68 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.

27.7 Transactions in securities

27.7.1 *Introduction*

The "lengthy and complicated"[13] 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?

(3) Does he obtain the tax advantage in circumstances within s.684(2) ITA (Circumstance A to E)?

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13 *IRC v Laird Group* [2003] STC 1349 at [13].

(4) Does he obtain the tax advantage in consequence of the transaction in securities?

(5) Does the escape clause apply?

27.8 "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.[14] However, a simple interest free loan is not in principle a "security" and so making such a loan is not a transaction in securities.[15]

27.9 "Income tax advantage"

"Income tax advantage" is defined in s.683 ITA:

> (1) In this Chapter "income tax advantage" means—

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14 *IRC v Parker* 43 TC 396.

15 For a discussion of the meaning of "security", see *Gore-Browne on Companies* paragraph 17.3; *Interests in Securities*, Benjamin, 1st ed., 2000, paragraphs 1.02 and 1.20.

(a) a relief from income tax or increased relief from income tax,[16]
(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.[17]

One must identify a hypothetical receipt to the taxpayer which would be taxable. This need not be the same kind of transaction as the actual transaction. In *IRC v Cleary*[18] 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 an entirely different kind of transaction: it reduced the company's assets

16 Section 683(3) provides "In this section 'relief from income tax' includes a tax credit."
17 43 TC 396 at 441 (emphasis added).
18 44 TC 399 at 423.

(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.[19]

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 UK resident foreign domiciled shareholder? 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".[20] But if the sum loaned is remitted there is an income tax advantage.

27.10 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.

---

19 *Williams v IRC* 54 TC 257 at 308. This assumes that the company has assets available for distribution.

20 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[21] 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".[22]

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—

---

21 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."

22 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 apply where there is a loan.

(a) a company under the control[23] of not more than 5 persons (but see subsection (2)), or
(b) any other company none of whose shares or stocks[24] 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.[25]

27.11 "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.

27.12 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,[26] or
(b) in the ordinary course of making or managing investments.
(3) Condition B is that enabling income tax advantages to be obtained is not the main object or one of the main objects of the transaction or,

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23 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')."

24 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."

25 This is self-evident but if authority is needed see *IRC v Wiggins* 53 TC 639.

26 On the meaning of "genuine commercial" see 19.6 ("Commercial").

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.

27.13 **Discussion**

27.13.1 *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.

But even if there is a transaction in securities, the escape clause may apply if the transaction is for commercial reasons.

27.13.2 *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.

CHAPTER TWENTY EIGHT

RATES OF INCOME TAX

28.1 Introduction

This chapter considers rates of income tax. I concentrate on two common types of income: interest and dividends.

It may be helpful first of all to list the eight possible rates of income tax on individuals:

Rate of tax	Amount	Applicable to
Starting rate	10%	Income up to starting rate limit
Savings rate	20%	Savings income up to basic rate limit
Basic rate	22%	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. DTR is not considered.

The rules are changing again in 2008/09. I will defer comment on that until the legislation is published. The ITA is, however, a considerable improvement on the labyrinthine provisions of ICTA.

28.2 Starting/basic/higher rates

Section 10 ITA introduces the starting/basic/higher rates:

> (1) Income tax is charged at the starting rate on an individual's income up to the starting rate limit.
> (2) Income tax is charged at the basic rate on an individual's income above the starting rate limit and up to the basic rate limit.
> (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.

28.3 Rates of tax on savings income

Section 12(1) ITA provides:

> (1) Income tax is charged at the savings rate on a person's income which—
> (a) is savings income, and
> (b) would otherwise be charged at the basic rate.

Section 12 replaces the basic rate with a different (more favourable) rate. The rule does not affect the starting or the higher rates.

28.3.1 *"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).

(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).

In short, the rates of tax on:

(1) UK interest; and

(2) foreign interest when the arising basis applies

are the starting/savings/higher rates, 10%/20%/40%.

28.3.2 *Rates of tax on interest under remittance basis*

Foreign interest income taxed on the remittance basis is taxed on the starting/**basic**/higher rates, 10%/**22%**/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 savings rate and the basic rate, 2%, for income between the starting rate and basic rate limits. In 2007/08, this is 2% of (£34,600–£2,230) = £647.40.

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 20%) or some other source of income (taxable at 22%). Because of this rule it is not necessary to ask this question.

28.4 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 starting or 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, and
> (b) would otherwise be charged at the higher rate.

The scheme of s.13 is to replace the starting/basic/higher rate with entirely different rates.

28.4.1 *"Dividend income"*

Section 19 ITA provides:

> (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.

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 distribution income is also taxed at the dividend ordinary/upper rates, 10%/32.5%, when the arising basis applies, but without the tax credit or grossing up.

28.4.2 *Foreign dividend income under remittance basis: 2007/08*

Foreign dividend income taxed on the remittance basis taxed at the starting/basic/dividend upper rate 10%/22%/32.5%.

28.4.3 *Foreign dividend income under remittance basis: 2005/06 and 2006/07*

The position in 2005/6 and 2006/7 is more complicated. Foreign distribution income remitted and taxed under the remittance basis is taxed at the starting rate/basic rate, 10%/22%, up to the basic rate limit.

What about income above the basic rate limit? In the fifth edition I said that remitted dividend income 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.[1]

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1 S.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).

But HMRC did not agree. Tax Bulletin 84 provides:

> **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.[2]

The Tax Bulletin did not explain how it reached its conclusion. The relevant legislation provides:

> *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*
> **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 United Kingdom in the tax year in respect of the income.

The (subtle) point seems to be that the charge is under sections 402 and

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2 The Tax Bulletin tries to minimise the embarrassment:

> This situation potentially only affects a very small number of individuals who can claim the remittance basis of taxation, are liable to income tax at the higher rate, and will be including on page F2 (of the Foreign Pages) dividend income from a non-UK company calculated by reference to the amount received in the UK in the tax year.

687 ITTOIA. Section 403 ITTOIA does not impose the charge. It merely quantifies the amount on which income is charged. Likewise section 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. Although the Tax Bulletin refers to dividend income, this reasoning applies equally to dividends and other income distributions from non-resident companies.

The Tax Bulletin explains what action should be taken by those affected in 2005/06 (text not set out here for reasons of space).

It is interesting that HMRC did not argue that the legislation should be read as imposing a 40% rate because 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.

Thus a person taxed under the remittance basis will need to identify whether a remittance is of dividends (taxed at the 10%/22%/32.5% rates) or other income (taxed at the starting/basic/higher rates, 10%/22%/40%). It is suggested that one can regard dividends as remitted first, out of a mixed fund of dividend and other income.[4]

Since the change made by ITTOIA was unintended, one would have expected the change to be reversed. But this has not happened. Perhaps it was judged politically tactful not to make changes on foreign domicile tax in minor respects, in case more questions were asked about the 2003 review of foreign domicile taxation.[5]

28.5 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

3 Hence the legislation stated that tax is charged "in accordance with s.832" not *under* section 832. See e.g. s.1A(4) ICTA.

4 See 9.32 (Mixed funds).

5 See 2.3 (Background paper on residence & domicile).

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 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 foreign domicile defence, but is later remitted and becomes taxable under the s.648 clawback?[6] This is taxable at the dividend ordinary/upper rates, 10%/32.5%.

28.6 Rates of tax on transferor within s.720 ITA

Sections 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

6 See 14.6 (s.624 foreign domicile defence).

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, at first sight interest within s.720 is taxed at the starting/basic/higher rates of 10%/22%/40% and not at the starting/**savings**/higher rate of 10%/**20%**/40%. However s.746 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.

It is tentatively suggested that s.12 ITA is a "relief" and so s.746(2) ITA restores the benefit of the savings rate. The difference is only 2%.

CHAPTER TWENTY NINE

CAPITAL GAINS TAX ON INDIVIDUALS

29.1 CGT and residence

Section 15(2) TCGA provides:

> Every gain shall, except as otherwise expressly provided, be a chargeable gain.

Thus all gains are in principle "chargeable gains" regardless of residence or domicile of the recipient.

However, s.2 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.

In principle, therefore, an individual 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 a clumsy one. In this chapter I generally abbreviate it to "non-resident" and leave "and not ordinarily resident" to be understood.

The non-resident individual 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 here).

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.

On years of arrival and departure see 6.15 (CGT: year of arrival and departure).

29.2 CGT remittance basis

Section 12(1) TCGA provides:

> [a] In the case of individuals resident or ordinarily resident but not domiciled in the UK,
> [b] capital gains tax shall not be charged in respect of gains accruing to them from the disposal of assets situated outside the UK
> [c] (that is, chargeable gains accruing in the year 1965–66 or a later year of assessment)
> [d] except that the tax shall be charged on the amounts (if any) received in the UK in respect of those chargeable gains,
> [e] any such amounts being treated as gains accruing when they are received in the UK.
>
> (Paragraphing added)

Section 12(1) contains two main rules: an exemption (limb [b]); and a corresponding charge under the remittance basis (limb [d]) with a timing

1 See 12.25 (Why does branch/agency matter?).

2 See 29.15 (Temporary non-residence). This is not technically an exception to the general rule, as the legislation does not impose a tax charge on the gains accruing to the non-resident. It deems the gains to accrue later when the individual is resident. But it comes to the same thing.

rule (limb [e]).

The CGT remittance basis applies only to foreign domiciled individuals. The use of the word "individual" means that trustees, personal representatives and companies do not qualify for the remittance basis. (By contrast the RFI remittance basis is slightly wider and can apply to some UK domiciled individuals and trustees.)[3]

The CGT remittance basis applies to foreign situate assets.[4] (By contrast, the RFI remittance basis applies to income from a foreign source; this is a different concept.) In particular, the CGT remittance basis applies to assets situate in Ireland. (By contrast, the RFI and employment income remittance bases do not apply to Irish source income.)

No claim is required, unlike the RFI remittance basis.[5] This is deliberate. Foreign domicile treatment will be advantageous to the taxpayer in most circumstances but not in relation to losses.[6] If a claim was required, an individual could elect for UK domicile treatment in a year he realised losses, and foreign domicile treatment in a year he realised gains.

A standard way of avoiding the RFI remittance basis is to remit after the termination of the relevant source of income. This does not apply to CGT which has no equivalent to the source doctrine.

Section 12(1)[c] is a necessary transitional provision to ensure that gains on pre-1965 disposals are not chargeable even if remitted after 1965.

There is no guidance on the position of an individual who changes his domicile during a tax year. It is suggested that gains accruing during the non-domiciled part of the year qualify for the remittance basis.

29.3 Meaning of "received in the UK"

The expression "received in the UK" is derived from the RFI remittance basis.[7] Its meaning is extended by s.12(2) TCGA:

> [a] ... there shall be treated as received in the UK in respect of any gain all amounts paid, used or enjoyed in or in any manner or form

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3 See 9.5 (Who qualifies for RFI remittance basis?) and 9.6 (Remittance basis for trustees).

4 Situs is discussed at 47.1 (Situs of assets for CGT).

5 See 9.9 (Claims).

6 See 29.18 (Capital losses).

7 See 9.12 (Remittance basis).

transmitted or brought to the UK, and
[b] sections 833 and 834 of ITTOIA shall apply as they would apply for the purposes of section 832 of that Act (remittance basis) if the gain were relevant foreign income.

(Paragraphing added)

Section 12(2)[a] extends the concept of receipt in the same manner as the employment income remittance basis.[8] This brings into charge land or chattels (representing gains) which are enjoyed *in specie* in the UK (but not assets which are merely UK situate but which are not enjoyed *in specie*).[9]

Section 12(2)[b] applies the deemed remittance rules; see 9.39 (Deemed remittances).

29.4 Date of disposal under remittance basis

Para.16(4) Schedule A1 TCGA provides:

> In relation to any gain that is treated by virtue of—
> (a) subsection (1) of section 12 or
> (b) subsection (2) of section 279 [delayed remittances][10]
> as accruing after the time of the disposal from which it accrues ...

Paragraph (a) applies to a gain taxed under the CGT remittance basis, under which gains are treated as accruing when received in the UK. Section 12(1)[e] gives a fictitious date of accrual (and, by implication, a fictitious date of disposal). The fiction is undone for taper relief. Paragraph 16(4) continues:

> ... references in this Schedule
> [a] to the disposal on which the gain accrues,
> [b] to the asset disposed of on that disposal and
> [c] to the time of that disposal
> shall be construed disregarding that subsection.

(Paragraphing added)

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8 See 10.13 (Meaning of "remitted to the UK").
9 See 10.14 (UK asset purchased out of employment income).
10 Delayed remittances are not important in practice; see 9.52 (Delayed remittances).

I cannot see the point of [a] or [b] but [c] is important: taper relief is calculated by reference to the actual date of disposal. The CG Manual provides:

> **17913. Foreign assets**
> TCGA 1992, s.12(1) provides that where a non-domiciled person disposes of a foreign asset, chargeable gains are taxed in the year (or years) in which the gains are remitted to the United Kingdom, see CG25310+. TCGA 1992, SCH A1, PARA 16(4) ensures that in this situation taper relief is calculated by reference to the actual period of ownership of the asset. The same provision applies where TCGA 1992, s.279(2) applies to defer liability where the taxpayer is unable to remit the proceeds to the United Kingdom because of the laws of the country where the gain accrued, or actions of its government, see CG78401+.
> EXAMPLE
> A non-domiciled taxpayer acquired a foreign non-business asset in May 1998 and disposed of it in August 2002. The gain was remitted to the United Kingdom in January 2005. There will be 4 whole years in the qualifying holding period for taper relief in respect of the gain that accrued in January 2005, which runs from May 1998 to August 2002. The delay in remitting the gain does not affect the length of the qualifying holding period.

But for other reliefs, the date the gain accrued (and by implication the date of disposal) is deemed to be the date of remittance. This will be relevant to claims for CGT roll-over relief or 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).[11] The time limits for rollover relief depend on the time of disposal,[12] but the drafter at [c] clearly considered that s.12(1)[e] TCGA altered the time of disposal.

29.5 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

11 Para 1 Sch 5B TCGA 1992.
12 Section 152(3) TCGA 1992.

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*[13] 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.[14]

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13 The italicised words are a sloppy 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.

14 Likewise the CG Manual:

> **25421 - Disposal of assets situated abroad: Example 1**
> Miss B sells an asset for net disposal proceeds of US $160,000 at a time when the sterling equivalent is £100,000. The proceeds include a gain of £25,000 equivalent to US $40,000. She pays US $120,000 into one Bank account and US $40,000 into another Bank account. Subsequently she remits US $60,000 to the UK out of the first Bank account.
> She may argue that since the payments to the Bank Accounts were equal respectively to the amount of the capital and the amount of the capital gain included in the disposal proceeds she has split those proceeds into capital and capital gains. She will then argue that her remittance is from an account containing only capital and that she is not liable to Capital Gains Tax as a result of making the remittance.
> We do not accept this argument. In our view the first account receives a deposit

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 constitute the profits of a trade. So it is considered that the HMRC view is correct.

A similar issue arises under section 13 TCGA (which attributes gains of a non-resident company to its shareholders). Section 13(5A) provides (so far as relevant):

> (5A) 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 …
> the amount of tax … shall be applied for reducing or extinguishing any liability of that person to income tax, capital gains tax or corporation tax in respect of the distribution.

Now, where a company has realised a gain within s.13, HMRC accept that the company *can* make a distribution of an amount "in respect of" the pure gain. CG Manual provides:

> **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

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made up of US $90,000 capital and US $30,000 capital gains. The second account receives a deposit made up of US $30,000 capital and US $10,000, capital gains. As explained in CG25401 above, we regard the remittance as composed of capital and capital gains in the same proportions as the funds in the Bank account immediately before the transfer. Accordingly we consider that Miss B has made a remittance of US $45,000 capital and US $15,000 capital gains.

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.[15]

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

The relief in s.13(5A) would not work sensibly if this were not the case. One might argue from this that in the context of the remittance basis too, an individual can make a remittance "in respect of" pure gain, so he can also make a remittance "in respect of" pure base cost, which will not come into charge for tax. However, the plastic expression "in respect of" must to a large extent take its meaning from context; the context of s.13(5A) is a relief against double taxation on the distribution of a gain which has borne tax. The context of s.12 is quite different, so guidance on the meaning of one section not a reliable guide to the meaning of the other.

29.6 Computation of remitted gains

CG Manual contains an example at CG25430 (so simple it is not set out here), and a more challenging example at CG25440:

25440 - Disposal of assets situated abroad: mixed funds: example 3

An individual, resident but not domiciled in the UK, has a foreign bank account

15 This was the rate of tax on foreign distributions in 1996.

in a foreign currency, F. The account contains the following entries:

November 1992	Balance	Nil
December 1992	Deposit - Partnership profits	10,000F
January 1993	Deposit - sale of shares (cost 10560F in December 1988)	15,000F
February 1993	Withdrawal - remitted to UK	20,000F
The rate of exchange is	2.2F = £1 in December 1988 2.0F = £1 in December 1992 and January 1993 2.5F = £1 in February 1993	

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
	Unindexed Gain	2,700
less	Indexation thereon £4,800 x .250	1,200
	Capital gain	1,500

Next, as in Example 2, we analyse the account. But this time we analyse it into income, capital and capital gains.

Sterling is the only appropriate measure of capital gains (see *Bently v Pike*, 53 TC 590 and *Capcount Trading v Evans* 65 TC 545). 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 £1,500 gains are represented by 3,750F 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 1992	10,000F			10,000F
Amount of Capital Gains			3,750F	3,750F
				13,750F
Figure of capital to balance		11,250F		11,250F
	10,000F	11,250F	3,750F	25,000F

The remittance of 20,000F is then regarded as coming:

a. to the extent of 10,000F from income, and
b. for the remaining 10,000F from capital and capital gain in the proportion 11,250:3,750.

The capital gain remitted is then $\frac{3,750 \times 10,000}{11,250 + 3,750}$ = 2,500F

= £1,000

The assessable gain is thus £1,000.

In computing CGT remittances the legislation requires unworkable computations in all but the simplest cases. HMRC take a realistic approach. CG Manual 25420 provides:

> **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.

29.7 Change of residence/domicile

Section 12(1)[a] TCGA applies "in the case of individuals resident but not domiciled in the UK". This section does not address the position where the status of the individual when a chargeable gain accrues is different from his status when the gain is remitted. The possibilities are as follows:

		Case 1	Case 2	Case 3	Case 4
R & D when gain accrues		Yes	-	-	-
NR	"	-	Yes	-	-
R & ND	"	-	-	Yes	Yes
R & D when gain remitted		-	-	-	Yes
NR	"	-	-	Yes	-
R & ND	"	Yes	Yes	-	-

Key

R:	*UK Resident*	*D:*	*UK Domicile*
NR:	*Non-UK Resident*	*ND:*	*Non-UK Domiciled*

It will be recalled that s.12 provides two rules. Firstly there is exemption from the charge on gains when they accrue. Clearly this can only apply when the individual is R & ND at the time the gain accrues. But there is also a rule that gains are deemed to accrue when remitted, and charged if remitted. How does this rule apply if there is a change in status?

29.7.1 *Resident and domiciled when gain accrues*

Case 1 is the individual who is R & D when the gain accrues, but R & ND when it is remitted. The individual is of course taxed when the gain accrues. No one suggests there is another charge on remittance. That would be absurd. It is considered that the two s.12 rules only apply if the individual is R & ND when the gain accrues.

29.7.2 *NR when gain accrues, R & ND when gain remitted*

If the above is correct, then s.12 does not apply in case 2, an individual who is non-resident when the gain accrues, even if he is R & ND when the gain is remitted. HMRC agree. CG Manual 25310 provides:

> An individual who becomes resident or ordinarily resident in the UK but remains domiciled abroad may have realised gains on assets located outside the UK before[16] he or she became resident in the UK. Those gains may be remitted to the UK after that individual has become resident. In applying the remittance basis the remittance of such gains should be ignored.

29.7.3 *R & ND when gain accrues, NR when gain remitted*

Case 3 is the individual who is R & ND when the gain accrues, and non-resident when the gain is remitted. Section 12[b] clearly applies when the gain accrues. It will be surprising if there were a charge when the gain is remitted, and HMRC accept that this is not the case.

CG Manual 25312–3 provides:

> **25312 Remittance basis/UK domicile**
> In other words the conditions for remittance basis to apply to gains arising from foreign assets are that
>
> - the individual realising the gains is within the charge to CGT at both the date of disposal and the date of remittance (ie is resident and/or ordinarily resident at those dates)

16 The meaning is, in clear tax years before becoming non-resident. For the year of arrival, see 6.15 (CGT on individuals).

and

- the individual was not domiciled at the date the gain was realised.

25313 Remittance basis/UK domicile

The individual's domicile status (although not his or her residence status) at the date of the remittance is irrelevant.

29.7.4 *R & ND when gain accrues, R & D when gain remitted.*

The last case is the individual who is R & ND when the gain accrues, but R & D when the gain is remitted.

Although s.12[a] clearly requires that the individual is non-domiciled, it does not say *when* the individual must be non-domiciled. The section might be read in the following ways:

[a] In the case of individuals resident or ordinarily resident but not domiciled in the UK,
  [i] *at the time gain accrues (status at time of remittance irrelevant)* **or**
  [ii] *at the time gain is remitted (status at time gain accrues irrelevant)* **or**
  [iii] *at the time gain accrues and at the time of remittance*
[b] capital gains tax shall not be charged in respect of gains accruing to them from the disposal of assets situated outside the UK
[c] (that is, chargeable gains accruing in the year 1965–66 or a later year of assessment)
[d] except that the tax shall be charged on the amounts (if any) received in the UK in respect of those chargeable gains,
[e] any such amounts being treated as gains accruing when they are received in the UK.

I refer to this as construction [i], construction [ii] and construction [iii]. But construction [i] is clearly wrong: it is inconsistent with the view taken above in case 3. Construction [ii] is also wrong: it is inconsistent with the view taken in case 1. So construction [iii], which is in any event the most natural reading, is to be preferred. In other words, the opening words in s.12[a] TCGA govern that the whole of the section. Thus there is no charge on remitted gains after acquisition of a UK domicile.

HMRC do not agree. CG Manual 25311 provides:

An individual who is resident or ordinarily resident but who has not been domiciled in the UK may change his or her domicile status and become domiciled from some date. If that individual:

- realised gains on foreign assets in the period when he or she was resident or ordinarily resident but not domiciled, and
- remits those gains after becoming domiciled

he or she should be assessed on the gains remitted in accordance with TCGA, s.12. The fact that he or she has become domiciled does not prevent assessment of the gains on the remittance basis.

But it is difficult to read s.12 to reach this result. One must add words into the section so that it reads:

[a] In the case of individuals resident or ordinarily resident but not domiciled in the UK,
[b] capital gains tax shall not be charged in respect of gains accruing to them from the disposal of assets situated outside the UK
[c] (that is, chargeable gains accruing in the year 1965–66 or a later year of assessment)
[d] except that *in the case of an individual resident or ordinarily resident at the time the gains are remitted but whether or not domiciled in the UK* the tax shall be charged on the amounts (if any) received in the UK in respect of those chargeable gains,
[e] any such amounts being treated as gains accruing when they are received in the UK.

The CGT position (if my view is correct) is consistent with the RFI remittance basis.[17]

HMRC may riposte that it seems anomalous that UK tax should be saved by acquisition of a UK domicile. The fact that the anomaly exists for RFI is not a powerful reason for extending it to CGT. A Court would be tempted to strain the construction of the section in order to uphold the HMRC view and prevent an unmerited tax saving. But the CGT deemed remittance rules do not apply if the individual has become UK domiciled and this shows that a strained construction will not give a satisfactory result, but only more anomalies.[18]

17 See 9.14 (Remittance after acquisition of UK domicile).

18 At first sight this seems a strong argument; but it only runs after the ITTOIA rewrite. Under the earlier legislation the point did not arise.

The HMRC approach is said to be supported by a decision of the General Commissioners but that of course carries no weight whatsoever.

So the better view is that the CGT remittance basis does not apply after acquisition of a UK domicile. However anyone taking this approach must expect an enquiry and perhaps litigation.

29.8 Gain on gifts and other deemed gains

29.8.1 *The CGT background*

In economic reality a gift cannot give rise to a gain and normally gives rise to a loss. However, for CGT purposes a disposal is treated as made for market value if (in the clumsy phrase of the statute) it is a disposal:

> otherwise than by way of a bargain made at arm's length.

On a disposal between connected persons, the transaction is treated as "otherwise than by way of a bargain made at arm's length"; see s.18(2) TCGA.

29.8.2 *Gift by foreign domiciliary*

The CG Manual at 25331–2 states:

> Where an individual assessable on the remittance basis has gifted foreign assets to another person and has not received any disposal proceeds he or she may still be deemed to have realised a gain on the disposal. As that gain is not represented by any money or money's worth in the hands of the individual making the gift, it is not possible for the individual to remit the gain. The gain arising on the making of the gift can therefore never become assessable.
> Similarly it is never possible to assess other deemed gains arising to such individuals from foreign assets when the gains are not represented by any asset that can be remitted to the UK.

This is correct, but in view of the importance of the point for tax planning it is reassuring to see it stated unequivocally in the Manual.

29.8.3 *Sale by foreign domiciliary to connected person*

Suppose now:

(1) F (not UK domiciled) transfers an asset (not UK situate) to B for (say) £100;

(2) F and B are connected persons; so the sale is treated as being for market value, and a gain (which may be more or less than £100) is treated as arising: ss.17,18, TCGA.

It is suggested that the £100 is to be regarded as a sum received "in respect of" the gain. If the sum is received in the UK there will be a charge to tax. If the £100 equals the market value of the asset then the computation is straightforward. Interesting questions arise on a sale at an undervalue. Supposing the asset is worth £200 and has a base cost of £50, giving rise to a deemed gain of £150. If the £100 is remitted it is suggested that one half of the deemed gain should be brought into charge, but other views are possible.

The same applies on a sale to an unconnected person if the disposal is otherwise than by way of a bargain made at arm's length.

29.9 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. Any gain is clearly 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.

29.10 CGT planning: avoiding a remittance of gains

If a foreign domiciliary has realised a foreign gain, he must attempt to avoid remitting the proceeds. It may be convenient to retain three types of funds in three accounts:

1. Relevant foreign income.

2. Proceeds of disposals representing substantial chargeable gains.

3. Proceeds of disposals which did not represent any (or any substantial) chargeable gains.

Then if funds are remitted to the UK they can be taken from account 3, and no (or no substantial) tax charge arises; then from account 2, where the gain is taxable but the tax charge is not on the entire proceeds remitted. Funds in accounts 1 and 2 (income and realised gains) can be given to others (while abroad) and a remittance by them would not be in principle taxable: see 9.30 (Transfer to third party completed abroad).

29.11 CGT planning: making UK situate property non-UK situate

29.11.1 *Moveable assets in UK*

Moveable assets could in principle be moved offshore prior to a disposal. Consider whether an export licence is needed.

29.11.2 *Unincorporated UK business carried on by foreign domiciliary*

This could be transferred to a foreign incorporated company under s.162 TCGA and shares later sold (or settled first). 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.

29.11.3 *Debts*

There are two ways to deal with a UK situate debt on a security if the debt is owed by a non-UK company. 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. See *Chitty on Contracts*, 29th ed, 2004 para.22-029 (Substituted contract).

29.12 Foreign currency and foreign currency bank accounts

The legislation deals separately with foreign currency bank accounts and foreign currency not in a bank account.

29.12.1 *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 rule is reversed for foreign currency bank accounts. Section 252(1) TCGA provides:

> **Foreign currency bank accounts**
> (1) 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 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 (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 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. Identification of disposals with acquisitions
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+.

29.12.2 *`Foreign currency not in a bank account*

Foreign currency is an asset on which a gain may accrue. CG Manual 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.

29.12.3 *Foreign currency for personal expenditure*

There are two exemptions for foreign currency needed for personal expenditure. These are not likely to affect foreign domiciliaries as gains on disposals of this kind are not likely to be remitted but I mention them for completeness. Section 269 TCGA provides:

Foreign currency for personal expenditure
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) is the corresponding provision for bank accounts:

> (2) 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 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.

29.13 CGT planning before disposal of foreign situate asset

A possibility would be to give the asset to a connected person. The connected person may be a trust created by the foreign domiciliary or a member of his family, or a company owned or controlled by him. A non-resident trust will often be the most convenient option. No CGT charge arises: see 29.8 (Gains on gifts and other deemed gains). The trust acquires the asset at market value. It may not realise a gain when the asset is sold in due course, by reason of its high acquisition value. And in any case a non-resident trust may be effectively outside the scope of CGT. In the case of the family home, a UK resident trust may be an easier option. Watch *Furniss v Dawson*.

29.14 CGT planning before acquisition of asset or trade

29.14.1 *A general policy*

Individual

Trust

Assets

A good general policy would be that assets on which a chargeable gain may arise should be acquired by a non-resident trust. The anti-avoidance provisions relating to offshore trusts do not apply to foreign domiciled beneficiaries and any gain made by the trustees can be remitted to the non-domiciled settlor in the UK without charge: see 30.2 (Charges to tax on offshore trusts). Take care that the trust is non-resident.

29.14.2 *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 that 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; see 47.4 (Registered shares). A possible drawback is that s.720 ITA will apply unless the motive defence can be used.[19] 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:

Foreign Domiciliary
|
Foreign Incorporated Co
|
UK Incorporated Co
|
Trade

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

19 See 15.5.1 (Foreign incorporated company) and 19.35 (Transfer to foreign incorporated company).

does not carry on a business. With a little care it can be arranged that a holding company does not carry on a business.[20]

29.15 Temporary non-residence

29.15.1 *The mischief*

Until 1998, a relatively simple method of CGT planning was as follows:

(1) An individual left the UK for the minimum period required to become non-resident.

(2) He disposed of assets during a year of non-residence.

(3) In the following year he could return to the UK.

Until 2005, a variant of this planning was:

(1) An individual became resident in a state with a DTT conferring CGT relief.

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20 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).

(2) The individual disposed of assets while resident in that state.

(3) Following the disposal the individual could return to the UK.

In practice this arrangement was used mainly by UK domiciled individuals. Section 10A TCGA is intended to prevent this, but applies to UK domiciled and non-domiciled individuals alike.

This is still possible for income tax, but not for CGT.

29.15.2 *The temporary non-residence rules*

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;[21]
> (c) there are fewer than five years of assessment falling between the year of departure[22] and the year of return; and
> (d) four out of the seven years of assessment immediately preceding the year of departure are also years of assessment for each of which he satisfied those requirements.

29.15.3 *"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,

---

21 Limb [ii] appears to be otiose, given paragraph (d); but it does not matter.

22 Section 10A(8) TCGA provides a commonsense definition:

> ""the year of departure" means the last year of assessment before the year of return for which the taxpayer satisfied the residence requirements."

unless he is Treaty non-resident during that year of assessment.

One has to read this more than once, to assimilate the double negatives, but essentially there are two ways to avoid the residence requirements (be either non-resident or treaty non-resident) and there is one way to meet the residence requirements (be resident and not treaty non-resident). Para (b) will not often, if ever, apply.

"Treaty non-resident" is defined 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.

An individual who becomes UK resident may be able to avoid the charge by remaining treaty non-resident. It is not necessary that the treaty confers CGT relief.

29.15.4 *Effect of s.10A*

The consequence of the section applying is set out in s.10A(2):

> 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,[23]
> (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, and ...
> were gains or, as the case may be, losses accruing to the taxpayer in the year of return.

Most DTTs with a capital gains article broadly adopt the OECD Model form:

---

23 s.10A(8) TCGA provides a commonsense definition:
"'intervening year' means any year of assessment which, in a case where the conditions in paragraphs (a) to (d) of subsection (1) above are satisfied, falls between the year of departure and the year of return."

> 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.

In the treaty the UK undertook that these gains should be relieved from UK tax, and s.10A (since 2005) is clearly in breach of that undertaking. However the intention of Parliament is reasonably clear and that prevails over the treaty.[24]

29.15.5 *Interaction with remittance basis*

Section 10A applies to a foreign domiciled individual. It may be fairly rare for foreign domiciled individual to reside in the UK for the minimum of four years, leave, and return within five years; but it will happen from time to time. If, in such cases, the individual disposes of UK situate assets while non-resident, he will be charged to tax on his return.

What about foreign assets? The interaction of s.10A(2) with the remittance basis raises some interesting questions. Section 12(1) provides:

> [a] In the case of individuals resident or ordinarily resident but not domiciled in the UK,
> [b] capital gains tax shall not be charged in respect of gains accruing to them from the disposal of assets situated outside the UK ...
> [d] except that the tax shall be charged on the amounts (if any) received in the UK in respect of those chargeable gains,
> [e] any such amounts being treated as gains accruing when they are received in the UK.

In all the following examples, "F" is a person non-UK domiciled but within the scope of s.10A: he has resided in the UK for a period ("the original UK resident period") sufficient to satisfy the requirement of s.10A(1)(d); he leaves the UK for one year ("the non-resident period") and then returns ("the year of return").

Example 1
F disposes of foreign assets during the non-resident period, realising a

24 *Padmore (No 2) v IRC* 73 TC 470.

gain, and does not remit the gain to the UK.

For the purposes of s.10A one must ascertain "the chargeable gains which (apart from s.10A(2)) would have accrued to him in an intervening year". The gain does accrue to F during the non-resident period.[25] So it is treated as accruing in the year of return, under s.10A(2). Then one applies the exemption in s.12(1)[b] so no CGT is charged. If F has a foreign domicile in the year of disposal but has acquired a UK domicile by the year of return, the remittance basis does not apply.

Example 2
F disposes of foreign assets during the non-resident period and remits the proceeds to the UK after the year of return.

Applying s.12(1)[d] [e], the gain is taxed in the year of remittance.

Example 3
F disposes of foreign assets during the non-resident period, and remits the proceeds to the UK in the non-resident period. The gains actually accrue in the intervening year, but under s.10A they are deemed to accrue in the year of return. Under s.12(1)[a] the gains are not taxed. There is no charge under s.12(1)[e] because the individual was not UK resident when the gains were remitted. So it is considered that there is no charge in this case.

Example 4
F disposes of foreign assets during the original UK resident period and remits the proceeds during the non-resident period.

There is no tax charge in these circumstances. Section 10A does not apply as (1) the gains do not accrue in the intervening year, and (2) s.12 does not deem the gains to accrue in that year.

29.16 Post-departure acquisitions

Section 10A(3) 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

25 s.12(1)[b] provides that CGT is not charged on the gain, but it does not say that the gain does not accrue on the disposal. Section 12(1)[e] does not apply.

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 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+.

29.16.1 *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
Section 10A(3)(b) TCGA 1992

- 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)[26] 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.
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 paragraphs (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

26 Original erroneously reads 23(4)(b).

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)[27] 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.
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+.

29.17 Section 10A and non-resident trusts/companies

29.17.1 *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

27 Original erroneously reads: 10A(d).

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.

29.17.2 *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 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 section 10A(2) by subsection (b), which applies sections 13 and 86 by deeming the taxpayer to be UK resident. It was not necessary to do this for s.87.

29.17.3 *Temporarily non-resident settlor: s.86 charge*

CG Manual 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.

Section 86A is a very complex section and not discussed here.

29.17.4 *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 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.

29.18 Capital losses

"Allowable losses" are in principle deductible for CGT. CGT is charged on *the total amount of chargeable gains less allowable losses* of a tax year (and unused losses of an earlier year): see s.2 TCGA. Section 16 TCGA explains the term "allowable loss":

> (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.
> (2A) 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.

Three important provisions restrict the term "allowable losses". Two are discussed here. For the third, s.16A TCGA, see 41.16.3 (Losses).

29.18.1 *Loss on disposal by 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.

A loss accruing to a person who is neither resident nor ordinarily resident in the UK is not an allowable loss. This is the corollary of the more general principle that a gain accruing to such a person is not a chargeable gain (leaving aside the exception for the UK branch or agency/permanent establishment). The realisation of losses outside the scope of CGT is wasteful and to be avoided wherever possible. The individual leaving the UK may consider realising his losses before he becomes non-resident and non-ordinarily resident. The individual returning to the UK may postpone the disposal of assets with inherent losses until he re-acquires UK resident status.[28]

29.18.2 *Loss on disposal by foreign domiciliary*

Section 16(4) TCGA provides:

> 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.

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.[29]

The rule is capable of acting harshly. A foreign domiciliary will be worse off than a UK domiciliary if:

(1) he realises losses on foreign situate property; and

(2) he realises gains:
   (a) on UK situate property; or
   (b) on foreign situate property and remits the gains to the UK.

It is, however, difficult to think of any better rule.[30]

It may sometimes be possible for a foreign domiciliary to avoid the problem by taking action before disposing of an asset on which a loss will

28 See also 6.16.1(Losses).

29 The section could be taken to mean that losses are not allowable on a disposal (by any person) to a foreign domiciliary; but that cannot be correct.

30 Relief on all losses is too generous when gains are taxed on a remittance basis. Relief on losses remitted to the UK seems sensible at first sight, but in practice 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 available to remit.

accrue. Consider:

(1) arranging that assets are situated in the UK prior to disposal, by a reversal of the techniques discussed in 29.11 (CGT planning: making UK situate property non-UK situate);

(2) inter-spouse transfer if the other spouse is UK domiciled; see 41.16.3 (Asset yielding a loss).

In practice, a foreign domiciliary would normally be able to avoid CGT on foreign situated assets and the restriction on allowable losses is a small price to pay for that privilege.

CHAPTER THIRTY

CAPITAL GAINS TAX AND TRUSTS

30.1 Basic principles

Section 69(1) TCGA provides:

> 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).

A trust is in principle treated as a single unit. If the trustees are UK resident,[1] they are subject to CGT. If non-resident, they are not subject to CGT[2] but various anti-avoidance provisions may tax the settlor or beneficiaries.

30.2 Charges to tax on offshore trusts

UK trusts are subject to CGT even if the beneficiaries have no connection with the UK. Offshore trustees are not subject to tax even if their beneficiaries are resident in the UK. It is usually an easy matter to select or appoint offshore trustees who will not be liable for CGT. Beneficiaries are, in principle, to be ignored and are taxed neither on trust gains nor on payments out of the trust.

If these principles were to be applied without qualification, CGT would be very easy to avoid. Little attempt is made to charge offshore trustees with CGT (unlike IT or IHT). However:

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1 On the concept of residence, see 5.1 (Residence of trustees).

2 Unless they carry on a trade in the UK through a branch or agency.

(1) If the settlor is UK domiciled and has an "interest in the settlement" (as widely and artificially defined) he will be liable to tax on gains accruing to the offshore trustees. See s.86 TCGA. I refer to this as the *s.86 charge*.

(2) UK domiciled beneficiaries of an offshore trust may be subject to tax if they receive capital payments from the trustees. See s.87 TCGA. I refer to this as the *s.87 charge*.

A full discussion of these rules requires, and has received, a long book to itself.[3] The discussion here is an outline only and focuses on issues concerning foreign domiciliaries.

30.3 The s.86 charge

Section 86 TCGA provides:

> **Attribution of gains to settlors with interest in non-resident or dual resident settlements**
> (1) 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;
> (b) the trustees of the settlement fulfil the condition as to residence [in short, are non-UK resident];
> (c) a person who is a settlor in relation to the settlement ("the settlor") is domiciled in the UK at some time in the year and is either resident in the UK during any part of the year or ordinarily resident in the UK during the year;
> (d) at any time during the year the settlor has an interest in the settlement;
> (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 ... (i) the assumption as to residence ... were made [in short, assuming UK resident trustees]
> ...
> (4) Where this section applies—
> (a) chargeable gains of an amount equal to that referred to in

3 Robert Venables QC, *Non-Resident Trusts*, 8th ed., 2000.

> subsection (1)(e) above shall be treated as accruing to the settlor in the year, ...

30.4 Section 86 foreign domicile defence

The s.86 charge applies if the settlor:

> is domiciled in the UK at some time in the year and is either resident in the UK during any part of the year or ordinarily resident in the UK during the year.

Section 86(1)(c) TCGA.

So the s.86 charge does not apply where the settlor is not UK domiciled. Note that (unlike IHT) it is not relevant where the settlor is domiciled at the time that the settlement was made. The s.86 charge will apply if the settlor is UK domiciled (and resident or ordinarily resident) in the year in which the gains accrue.

30.5 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 Schedule 5 paragraph 8, see 45.3.6 (CGT s.86 definition).

30.5.1 *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 foreign domiciled and B is UK domiciled, 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 45.13 (Provision of property for company held by trust). A "just apportionment" is practical, though it may not be easy.

The CG Manual contains the following unexceptionable guidance:

> **34894. Multiple settlors** [March 2006]
> If IR Trusts–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. Districts should endeavour to reach a fair and easily worked solution.[4]

30.5.2 *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.

There are two settlors, an indirect settlor ("A") and a direct settlor ("B").[5] Both have provided the *same* property. No issue arises if A and B are both foreign domiciled. What is the position if they are both UK domiciled? 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 strongly arguable that there is no tax charge at all. The Courts would have taken that view in the past: see *Lord Herbert v IRC* 25 TC 91. It is possible that a Court applying a "never mind the words" purposive approach would seek to identify a "real" settlor (presumably B) and infer that A is not to be regarded as the settlor.

If A is UK domiciled 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 unmeritorious 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 45.32 (Tax planning to create settlement with foreign domiciled settlor).

If A is not UK domiciled and B is UK domiciled, there is no double charge. B can argue that he is not the "real" settlor. In practice this factual situation should not arise.

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4 The Manual continues with an anodyne example not printed here.

5 See 45.4 (Gift to B followed by gift to trust by B).

30.6 The s.87 charge

Section 87 TCGA provides:

> **Attribution of gains to beneficiaries**
> (1) This section applies to a settlement for any year of assessment during which the trustees are at no time resident and ordinarily resident in the UK.
> (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 ... if they had been resident and ordinarily resident in the UK in the year; and that amount ... is ... referred to as the trust gains for the year.
> ...
> (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.

For the meaning of "settlement" see 44.3.1 (Is an estate a "settlement" for s.87?).

30.7 "Capital payment"

"Capital payment" is defined in s.97(1) TCGA:

> ... "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,[6] but
> (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.

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6 As to what is an income/capital receipt from a trust, see 8.21 (Payment from discretionary trust: income or capital?).

What is the position if a UK resident foreign domiciliary receives unremitted income from a non-resident trust? The word "chargeable" takes its meaning from the context. It is suggested here in this context that the income is "chargeable to income tax" even if it is not taxed because of the remittance basis. Otherwise whenever a trust distributes income to a UK resident foreign domiciliary it also makes a "capital payment" (and washes trust gains); a court would think that result very odd.

30.7.1 *"Payment"*

Section 97(2) TCGA provides:

> (2) In subsection (1) above references to a payment include references to the transfer of an asset and the conferring of any other benefit, and to any occasion on which settled property becomes property to which section 60 applies.

On the meaning of "benefit" see 17.4 (Benefit).

30.7.2 *Amount of capital payment*

Section 97(4) TCGA provides:

> For the purposes of sections 86A to 96 and Schedule 4C the amount of a capital payment made by way of loan, and 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.

30.8 Receipt by a beneficiary

Section 97(5) TCGA provides:

> 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.

30.9 Section 87 foreign domicile defence

Section 87(7) TCGA provides:

> A beneficiary shall not be charged to tax on chargeable gains treated by virtue of subsection (4) above as accruing to him in any year unless he is domiciled in the UK at some time in that year.

I call this the s.87 foreign domicile defence.

A beneficiary who is not domiciled in the UK at any time during the tax year is altogether exempt from the s.87 charge regardless of his residence or ordinary residence and regardless of the domicile of the settlor. This exemption is much more generous than the remittance basis, for the beneficiary may receive the capital payment in the UK free of CGT.

30.9.1 *Change of domicile of beneficiary*

The beneficiary qualifies for the relief if he is domiciled outside the UK throughout the year that the gain is deemed to have accrued to him. That is the later of:

(1) the year of the capital payment; and

(2) the year the trust gains accrue.

If, therefore:

(1) the capital payment is made in year 1 when the beneficiary is not UK domiciled; and

(2) the trust has no "trust gains" at that time; and

(3) trust gains accrue in a later year ("year 2") during which the beneficiary is UK domiciled,

then the foreign domicile relief does not apply.

The position would be different if trust gains equal to (or exceeding) the capital payment accrued in year 1. In that case, the trust gains of year 2 would not be attributable to the beneficiary, even if he has become UK domiciled by then. Section 87(5) provides:

> 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.

30.10 Four basic strategies for the s.87 charge

In outline the position is as follows:

30.10.1 *Indefinite deferral*

This is obvious and straightforward. 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 abroad and any trust gains reinvested there. The beneficiaries of the settlement would enjoy immediate or (if the trust income is accumulated) long-term benefits of 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, and the s.87 charge remains no more than a cloud on the horizon.

30.10.2 *Non-resident beneficiary*

Trust gains 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 capital 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. For temporary non-residence rules, see 29.15 (Temporary non-residence).

30.10.3 *Mixed UK and foreign beneficiaries: simple capital payments*

Trust gains which have been attributed 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 capital payments had been attributed to a non-resident or a foreign domiciled beneficiary and the capital payments equal the total trust gains. Those gains 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. Correct timing is of vital importance. 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. Subsequent trust gains may be taxed on the UK beneficiary.

30.10.4 *Mixed UK and foreign beneficiaries: capital payment and resettlement*

If one or more of the beneficiaries of the settlement are not domiciled in the UK, the trustees might consider advancing trust capital to those beneficiaries absolutely. The beneficiaries might then independently resettle the property and gain additional inheritance tax advantages. The CGT position would be substantially improved for the other beneficiaries by washing out an amount of trust gains equal to the advancement. But successfully implementing arrangements of this kind is easier said than done. See Example 2 in 45.32 (Tax planning to create a settlement with foreign domiciled settlor).

30.11 Transfer between trusts

Section 90 TCGA provides:

> **90 Transfers between settlements**
> (1) If in a year of assessment for which section 87 or 89(2) applies to a settlement ("the transferor settlement") the trustees transfer all or part of the settled property to the trustees of another settlement ("the transferee settlement") then, subject to the following provisions—
> (a) if section 87 applies to the transferee settlement for the year, its trust gains for the year shall be treated as increased by an amount equal to the outstanding trust gains for the year of the transferor settlement or, where part only of the settled property is transferred, to a proportionate part of those trust gains;
> (b) if subsection (2) of section 89 applies to the transferee settlement for the year (otherwise than by virtue of paragraph (c) below), the trust gains referred to in that subsection shall be treated as increased by the amount mentioned in paragraph (a) above;
> (c) if (apart from this paragraph) neither section 87 nor section 89(2)

applies to the transferee settlement for the year, subsection (2) of section 89 shall apply to it as if the year were the first year of a resident period succeeding a non-resident period and the trust gains referred to in that subsection were equal to the amount mentioned in paragraph (a) above.

(2) Subject to subsection (3) below, the reference in subsection (1)(a) above to the outstanding trust gains for the year of the transferor settlement is a reference to the amount of its trust gains for the year so far as they are not treated under section 87(4) as chargeable gains accruing to beneficiaries in that year.

(3) Where section 89(2) applies to the transferor settlement for the year, the reference in subsection (1)(a) above to the outstanding trust gains of the settlement is a reference to the trust gains referred to in section 89(2) so far as not treated as chargeable gains accruing to beneficiaries in that or an earlier year.

(4) This section shall not apply to a transfer so far as it is made for consideration in money or money's worth.

(5) This section does not apply—

(a) to a transfer to which Schedule 4B applies, or

(b) to gains to which Schedule 4C applies (that is, to "Schedule 4C gains" within the meaning of that Schedule).

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.

30.12 CGT problems on termination of a non-resident settlement

If the settlement comes to an end, outstanding trust gains at that time will be attributed to the beneficiaries who become entitled to the trust property: s.97(2) TCGA. This rule will 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 diarise the date when the settlement may come to an end so as to take action beforehand.

30.13 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 trust gains: s.13 TCGA. 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. However, this will normally be of concern only to UK domiciled settlors or beneficiaries.

30.14 CGT planning: offshore trusts and companies

In the short and medium term the foreign domiciliary may be content to use the remittance basis to avoid any CGT liability.[7]

In the longer term, this is likely to become unsatisfactory and something more is required. The principle of the foreign domiciliary's long-term CGT planning is that the foreign domiciliary should hold his wealth through the medium of an offshore trust. The offshore trustees will not be subject to CGT in any event, and neither will foreign domiciled beneficiaries, even if all the gains are remitted to the UK.

30.14.1 *Creating the settlement*

The creation of an offshore trust presents no CGT problem if:

(1) the individual is non-resident; or

(2) the asset transferred is sterling; or

(3) the asset transferred is not UK situate; or

(4) the asset transferred does not give rise to a gain.

For UK assets with inherent gains, see 29.11 (Making UK situate property non-UK situate).

The creation of an offshore trust presents IHT problems for an individual who is deemed UK domiciled. One course would be to lend the initial trust fund. The IHT position would need to be reviewed before the ten

7 See 29.10 (CGT planning: avoiding a remittance of gains).

year anniversary, but in principle it should be possible to avoid any ten year charge. Another course would be not to use a trust, but some other structure such as a company or unit trust.

30.15 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 will in principle be a "migration" charge under s.80 TCGA.[8] 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: s.65(2) TCGA.

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.

30.16 UK resident settlor-interested trust

30.16.1 *The charge*

Section 77(1) TCGA provides, 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

8 It is likely that no charge arises on a migration to another EU state.

[ii] instead chargeable gains of an amount equal to that referred to in paragraph (b) shall be treated as accruing to the settlor in that year.

(Paragraphing added)

"Settlor interested" is defined in s.77(2)(2A):

> (2) Subject to the following provisions of this section, a settlor shall be regarded as having an interest in a settlement if—
> (a) any property which is or may at any time be comprised in the settlement, or any derived property is, or will or may become, payable to or applicable for the benefit of the settlor or his spouse or civil partner in any circumstances whatsoever, or
> (b) the settlor or his spouse[9] or civil partner enjoys a benefit deriving directly or indirectly from any property which is comprised in the settlement or any derived property.
> (2A) A settlor shall also be regarded as having an interest in a settlement (subject to the following provisions of this section) if—
> (a) any property which is or may at any time be comprised in the settlement, or any derived property, is, or will or may become, payable to or applicable for the benefit of a child of the settlor, at a time when that child is a dependent child[10] of his, in any circumstances whatsoever, or
> (b) a dependent child of the settlor enjoys a benefit deriving directly or indirectly from any property which is comprised in the settlement or any derived property.

I refer to gains within s.77 TCGA as "section 77 gains".

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9 Spouse and civil partner are defined in subsection (3).

10 Dependent child is defined in subsection (3A):

"(3A) In this section—
(a) "dependent child" means a child who—
(i) is under the age of 18 years,
(ii) is unmarried, and
(iii) does not have a civil partner, and
(b) "child" includes a stepchild.

(3B) For the purposes of subsection (2A) above no account shall be taken of a term of a settlement relating to dependent children of a settlor in respect of any time at which he has no dependent child."

30.16.2 *Foreign domiciled settlor*

An interesting question arises where the settlor is foreign domiciled, UK resident, and has an interest in the trust (as defined).

Suppose the trustees dispose of assets situated outside the UK. Does the remittance basis apply? HMRC say no.[11] CG Manual 34911 provides:

> The remittance basis of assessment provided by Section 12 TCGA, see CG25300+, does not apply to trust gains attributed to a settlor who is not domiciled in the UK. If settled property situated outside the UK is disposed of by trustees, the chargeable gain which in consequence is treated as accruing to the settlor does not accrue to that person *by reason of* the disposal of assets situated outside the UK. It accrues as a consequence of the operation of the statutory provisions. The requirements of Section 12(1) are therefore not satisfied.
>
> (Emphasis added)

Now, s.12 TCGA provides that CGT shall not be charged "*in respect of* gains accruing to the foreign domiciliary ("F") *from* the disposal of assets situated outside the UK".

Note first of all that section 77 gains do accrue to F, and section 12 does not require that there must be disposal by F.

The HMRC argument set out above is wrong (or at least wrongly expressed) because it asks the wrong question. The issue is not whether the gain accrues *by reason of* the disposal of foreign assets. The issue is whether s.77 imposes a charge to CGT *in respect of* gains accruing to F *from* the disposal of foreign assets.

HMRC could reformulate their argument and say that the gains accruing to F do not arise from the disposal of the trustees' assets but only as a consequence of s.77. But the fact that it needs a statutory provision to deem the gain to accrue to F should not mean that the gain does not accrue *from* the disposal of the foreign assets.

A better HMRC argument is that s.77 does not deem the gains from the

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11 This is also the view of Robert Venables QC: *Non-Resident Trusts*, 8th ed., 11.6.4 (Charge on settlor with interest in settlement – UK settlor provisions). A similar question is whether gains taxed under s.77 may qualify for private residence relief under s.222 TCGA (where s.225 TCGA does not provide relief).

assets to accrue to the settlor, but *chargeable gains of an amount equal* to those gains.[12] However, the distinction between a chargeable gain and an amount equal to a chargeable gain is so slender as to be meaningless. The two gains can be identified. Even if they cannot be identified, the artificial gain deemed to accrue to the settlor should still be said to arise *from* the disposal of the foreign assets by the trustees; there is a clear, albeit indirect causal link.

Does the purpose of s.77 shed any light on the issue? To answer this we have to identify the purpose of s.77. When s.77 was introduced, its purpose was perfectly clear. It was to prevent CGT avoidance which would otherwise be possible where:

(1) A settlor makes a gift to a settlor-interested trust.

(2) The trustees realise a gain and pay tax at less than the settlor's rate.

(3) The trustees then return the trust fund to the settlor, or apply it in some way for his benefit.

Section 77 achieves its aim and stops this scheme.[13] Note that s.77 engages in fantastic overkill, since it applies even if the settlor (or spouse/civil partner) has only a relatively small interest in part of the trust fund. But overkill is often a feature of anti-avoidance provisions. Perhaps the thinking was that separate taxation (between trust and settlor) requires a complete separation of interest. There are different ways one might express the philosophy which lies behind s.77:

(1) One might say that a settlor of a settlor-interested trust should be subject to CGT as if he had never given away the asset.

(2) One might say that the trustees of a settlor-interested trust should be

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12 Similar questions arise in relation to DTT relief where the trust is resident in a jurisdiction with a double tax treaty. See *Taxation of Non-Resident Companies and their Shareholders*, Stephen Brandon QC, Key Haven Publications.

13 This is stated in the Trusts Consultative Document, 1991, para.13.3. Since the trust CGT rate was increased to 40%, the maximum individual's rate, it is extremely hard to see the purpose of s.77, let alone of extending it as was done in the Finance Act 2006. The only basis is a misconceived analogy with the IT settlement provisions.

subject to tax at the settlor's marginal rate (since they ultimately bear the burden of the tax).

Either way, the purpose is consistent and supports the conclusion reached here.

Do anomalies help resolve the position? The main anomaly on which HMRC will rely is that they do not receive any tax, whereas if the settlor had no interest, or was non-resident, they would. But this is not an anomaly, it is consistent with the scheme of s.77. It may be said that there is an anomaly that the beneficiaries may all be UK domiciled, and ride on the back of the settlor's domicile exemption. But this follows from the scheme of the legislation to engage in overkill, taxing a settlor where he (or his spouse/civil partner) has only a trivial interest in the trust. A genuine anomaly is that trust losses are allowable against trust gains, without restriction for non-UK situate assets, which is not the case with the settlor's own losses. But that anomaly lies deep in the details of the legislation, and hardly sheds light on the answer.

Comparisons can be drawn with s.624 ITTOIA, but that section operates in an entirely different way and does not shed much light on the CGT issue.

Note that if the settlor were to die in the same year of assessment, the gains would not be attributed to him (see s.77(6) TCGA) and the UK trustees would be chargeable.

CHAPTER THIRTY ONE

DEEMED DOMICILE FOR IHT

31.1 The three classes of domicile for inheritance tax

The general concept of domicile is discussed in Chapter 3. In principle, an individual must have either a UK domicile or a foreign domicile; there is no middle way. But a foreign domiciliary can often secure effective exemption from inheritance tax and can live indefinitely in the UK without acquiring a UK domicile of choice. The inheritance tax code therefore distinguishes the foreign domiciliary who has close UK connections and provides that for most (but not all) purposes, such an individual is to be treated as if he were a UK domiciliary. The IHTA has failed to supply a suitable term for its new conception. In this book I shall refer where necessary to three classes of individuals as:

(1) True or actual UK domiciliaries;

(2) Deemed UK domiciliaries (or deemed domiciliaries); and

(3) True or actual foreign domiciliaries.

31.2 Deemed UK domicile

31.2.1 *The statute*

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.

31.2.2 *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.

31.2.3 *The 17 year residence rule*

The second rule concerns the person who is not a true UK domiciliary but who becomes resident here. Once he has been resident in the UK for seventeen out of the last twenty years of assessment he becomes deemed domiciled here under the seventeen year residence rule.

Note that the immigrant foreign domiciliary does not need to be present in the UK for seventeen 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 year of assessment 1982/83. (Although this seems unlikely, this would be the HMRC view, under paragraph 3.1 of IR20 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 seventeen year residence condition would then be satisfied.

31.2.4 *Comparison of the two rules*

The seventeen year residence rule may be stricter than the three year domicile rule. 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 three 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 seventeen year residence rule until 6 April 2002, the start of the year 2002/03.

By contrast, 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 seventeen year residence rule. But three more years must pass before he ceases to be UK domiciled under the three year domicile rule.

31.3 Deemed domiciliary leaving the UK

Suppose:

(1) A person who is not actually UK domiciled becomes deemed UK domiciled, having spent seventeen tax years resident here.

(2) He then ceases to be resident in the UK. In the following tax year he ceases to satisfy the seventeen year rule.

Is the person still treated as domiciled here for three years under the three 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. The better view is that (a) and (b) are independent rules dealing with separate circumstances. This interpretation would be consistent with the reasoning in *Russell v IRC* [1988] STC 195. 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 domicile. 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 true domicile and not deemed domicile. The word should have the same meaning throughout the section.

31.4 Domicile of child of a deemed domiciliary

A child under 16 usually takes the domicile of the father as a domicile of dependency and that domicile changes with the domicile of the father. If the father is treated as UK domiciled under s.267, is the child treated as having acquired a UK domicile of any type? Suppose a man becomes deemed domiciled in the UK at a time when he has a 15 year old son. Does one say that since the father is treated as UK domiciled, the child is likewise treated as having a UK domicile of dependency? The question will not often arise, since the domicile of children and young persons only rarely needs to be ascertained. The author takes the view that the child will not be deemed to be UK domiciled in such circumstances. Section 267 does not affect the true domicile, as it expressly applies only to persons who are not domiciled in the UK and the child's domicile of dependence should remain unaffected. The child's domicile has to be determined first by the general law and only then do his own residential circumstances need to be examined to see whether he is deemed domiciled himself.

31.5 Meaning of "residence" for deemed domicile 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.

However, 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.[1] This remains significant when determining residence for the years up to 1992/93 which will feature as part of the seventeen year calculation until 2010. IHT Manual para 13024 provides:

> We follow any residency rulings made by CNR with one qualification.

1 See 4.5 (Accommodation in the UK).

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.

31.6 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).[2]

31.7 When deemed domicile does not matter: exempt gilts and DTT

There are two situations where a deemed domicile rule does not apply: exempt gilts (discussed here) and pre-1975 double tax treaties.[3]

Section 267(2) IHTA provides:

> Subsection (1) above shall not apply for the purposes of section 6(2)

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2 There is also a relief for the property of visiting forces: see 33.7 (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 persons are “referred to” in s.155(1).

3 See 40.1 (IHT double tax reliefs).

> or (3) or 48(4) above ...

That is, the deemed domicile rules do not apply for the purposes of the exemption allowing exempt gilts to be excluded property.

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. Although new gilts could have been made subject to a deemed domicile rule, the decision was made to treat all gilts in the same way.

A person can avoid IHT by holding exempt gilts if:

(1) he is deemed domiciled but not actually domiciled in the UK; and

(2) he is not ordinarily resident in the UK.

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) in the FA 1975. 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 give further encouragement for foreigners to invest in exempt gilts.

31.8 Pre-1974 transitional rules

Section 267(3) contains five transitional rules:

> Paragraph (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 paragraph (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.

31.9 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 37.6 (Borrowing and acquisition of 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 domiciled (in reality) 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: see 33.6 (Individual domiciled in Channel Islands or Isle of Man). 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.

CHAPTER THIRTY TWO

DOUBLE TAXATION TREATY DEFENCE TO ANTI-AVOIDANCE PROVISIONS

32.1 DTTs in UK law

This chapter considers whether DTTs offer a defence to various income tax and CGT anti-avoidance provisions.

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; ...

This is extended to CGT by s.277(1) TCGA 1992.[1]

For convenience I shall where appropriate refer to income tax and leave

1 "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."

CGT to be understood.

32.2 Can a third party claim treaty relief?

Suppose income accrues to a trust or company in a treaty jurisdiction, but the settlor or transferor in the UK is subject to tax under an anti-avoidance provision such as s.624 or s.720. DTT relief is not necessarily restricted to the trustees or person abroad. If the DTT provides the relief, the UK statute clearly authorises the relief to apply, for s.788(3)(a) ICTA simply provides "relief", ie relief for anyone.[2]

This is self evident, but authority can be cited if necessary. In *Lord Strathalmond v IRC*[3], 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 a resident of the US (within the meaning of the DTT) but the husband was not. Nevertheless he was entitled to the benefit of the treaty. The important point was that the treaty exempted the income, not the resident, so a third party otherwise taxed on the income, US resident or not, could claim the benefit of it. 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.[4]

Again, in *Padmore v IRC,* 62 TC 352 a UK resident partner was able to claim treaty relief on income of a Jersey partnership.

I stress this because there is a comment to the contrary by the special commissioner in *IRC v Willoughby*[5] but that must be dismissed as erroneous.

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2 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.

3 48 TC 537.

4 *Bricom v IRC* 70 TC at p 290.

5 [1995] STC 143 at p.169.

32.3 Characterisation of income

DTTs provide exemption for particular types of income, and 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. Assuming the income in the hands of the actual recipient qualifies for relief, does the UK taxpayer receive (or is he deemed to receive) the same income? Or has the income "changed its character" (in which case the relief does not apply)?

DTT relief does apply where a UK statutory provision deems the income of the person abroad to be the income of the taxpayer: *Strathalmond* is such a case. Lord Millett summarised:

> 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.*

The same applies if the UK provision apportions that income to the taxpayer: "apportion" has the same meaning as "deems to accrue to" or "impute".[6]

Hughes v Bank of New Zealand[7] concerned exemption for gilts, not a DTT, but the question was the same. The 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). It was held that the exempt interest retained its exempt status in the hands of the London branch. 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.[8]

6 *Bricom v IRC* 70 TC at p 290.

7 21 TC 472.

8 *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.

On the other side of the line, according to Lord Millett, is *IRC v Australian Mutual Provident Society*[9]. This concerned an non-resident life assurance company which had a branch in the UK whose profits were taxable. In such a case 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 a conventional sum calculated in accordance with the rule; and that accordingly the sum to be taxed was not affected by the fact that one of the elements in the calculation represented income from exempt gilts.

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 Mutual Provident Society.*

IRC v Willoughby offers another example. Here the taxpayer paid a premium to Royal Life. Under s.720 he was (in principle) subject to tax on the income accruing to Royal Life from the premium. Royal Life in turn was subject to tax on its trading profits. The DTT provided relief for the commercial profits of Royal Life; but the income on which the taxpayer was subject to tax could not be characterised as the commercial profits of Royal Life (it was merely an element by reference to which those profits were computed). So the DTT did not confer relief on the taxpayer.[10]

32.4 Distinction between income and sum equivalent to income

Bricom v IRC decided that a DTT did not provide a defence to the

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9 28 TC 388 "as explained by Lord Radcliffe" in *Ostime v Australian Mutual Society* [1960] AC 459, at p. 479, 38 TC 492; discussed in *Bricom v IRC* 70 TC at p.290.

10 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 this point.

Controlled Foreign Company ("CFC") provisions. These provisions require a three-stage operation to be undertaken:

> Stage 1. *Ascertainment:* the CFC's chargeable profits are ascertained under s 747(6)(a) ICTA and Sch 24.
> Stage 2. *Apportionment:* the CFC's chargeable profits (less any creditable tax) are apportioned among its shareholders. *Bricom* concerned "Spinneys" a wholly-owned subsidiary of 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 the interest lost its character as interest by the end of 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 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 purely 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. At this point the error slips in:

> Nor do they represent any actual payments or receipts of Spinneys,

> whether of interest or anything else.

Why not?

> 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 taxpayer (it seems) raised this distinction and lost on it:

> They are merely the product of a mathematical calculation made on a hypothetical basis and making counterfactual assumptions. 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 taxpayer was wrong to accept a purely formal distinction between interest and a sum equivalent to interest. No reference was made to 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.[11]

Nevertheless that formal distinction now seems settled, at least below the level of the House of Lords.

Even if the formal distinction is accepted, the decision of the Court of

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11 *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").

Appeal that the CFC legislation imposed a tax charge on a notional sum (no DTT relief) and not on interest (which qualified for DTT relief) is not particularly convincing, but a distinction without a difference is always going to be difficult to apply, and it is not worth pursuing that point here.

It is worth stepping back to remember that the purpose of double tax treaties is to allocate taxing rights between countries. While the UK can deliberately breach a treaty, tax legislation should be construed consistently with a treaty where possible. 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. That would have been just. But it is not necessary to pursue that point in this book. For the time being, at least, one must ask whether under the anti-avoidance provision, the taxpayer receives income (within the scope of treaty relief) or a sum equivalent to the income, a notional sum (not within the relief).

32.5 DTTs and s.624 ITTOIA

Under s.624 ITTOIA, "Income which arises under a settlement is treated for income tax purposes as the income of the settlor and of the settlor alone." Clearly this is the same income as accrues to the trustees, so applying a *Bricom* formalistic approach, if the income qualifies for DTT relief, the settlor can claim it.

32.6 DTTs and s.720 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 conditions A and B are met.

It appears that under s.720 the income which is *treated* as arising is *not* the same income as that accruing to the person abroad, so applying the *Bricom* formalistic distinction, treaty relief is in principle not available for s.720 (though the point is remains arguable in the House of Lords). This view is not universally held. Rebecca Murray 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 United Kingdom.
> (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.[12]

The references in s.721(2)(3)(4) and (5) are to the actual income, but this does not mean that the reference in s.721(1) is the actual income.

Section 726 ITA is perhaps more helpful:

> (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 does seem to equate the income treated as accruing with the actual income of the person abroad. My conclusion is that s.720 is somewhat 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

12 *Taxation* vol.159, 7 June 2007 at p.640.

merely fictional income. This only goes to show that the *Bricom* approach which attempts to distinguish between the two is a mistaken approach.

The pre-ITA wording was different, and it is considered that DTT relief was available up to 5 April 2007.[13]

For s.731 ITA it is clear that treaty relief is not applicable, and that was also the position under the pre-ITA wording.

32.7 DTTs and s.13 TCGA 1992

Section 13 TCGA provides:

> (1) 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.
> (2) Subject to this section, every person who at the time when the chargeable gain accrues to the company
> [a] is resident or ordinarily resident in the UK,
> [b] who, if an individual, is domiciled in the UK, and
> [c] 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.
> (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.

32.7.1 *Individual or UK company holding offshore company*

Where the offshore company is resident in a treaty jurisdiction with a CGT article, DTT relief can in principle apply to gains accruing to individuals or companies under s.13 TCGA 1992. HMRC accept this. The CG Manual provides at 57380:

> **Double taxation agreements**
> You should always check whether there is a double taxation agreement

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13 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.

> 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 Capital Gains Tax 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 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.

The Kenyan DTT follows the standard OECD Model wording, so what is stated here of Kenya is generally true for DTTs which have a CGT article.

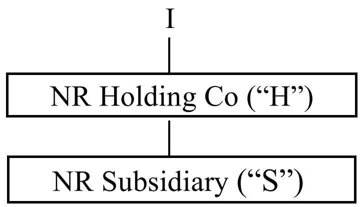
32.7.2 *Trust holding offshore company*

For trusts holding offshore companies in a treaty jurisdiction, treaty relief is overridden by s.79B TCGA 1992:

> **79B Attribution to trustees of gains of non-resident companies**
> (1) This section applies where the trustees of a settlement are participators—
> (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.
> For this purpose "participator" has the same meaning as in section 13.
> (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 section 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.

32.7.3 *Chain of companies owned by individual*

Suppose an individual "I" owns a non-resident holding company which holds a non-resident subsidiary:



Gains accruing to S are not attributed to H under s.13(2) because H is not UK resident. See s.13(2)[a]. Gains accruing to S would (perhaps) not be attributable to I under s.13(2).[14] Section 13(9) TCGA addresses this:

> [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] 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 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, and so on through any number of companies.

The apportionment in s.13(9)[b] is:

> *an amount equal to* the amount apportioned under subsection (3) above out of the chargeable gain

An individual can claim DTT relief even though what is apportioned to him is expressed to be an amount equal to the gain and not the gain itself.

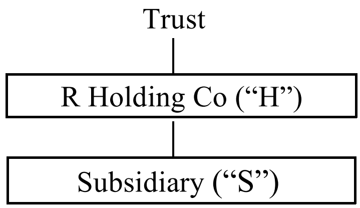
32.7.4 *Chain of companies owned by trust*

Suppose:

14 Actually under the current version of s.13, gains accruing to S would be attributable to I, since I is a participator in S, but this was not the case with the original version of s.13 which referred to shareholders not participators.

(1) a trust owns a holding company ("H") which is UK resident;

(2) H holds a non-resident subsidiary ("S"):



H would not be taxed under s.13 on gains accruing to S if S is resident in a country with an appropriate DTT.

Section 79B(3) TCGA therefore deals with chains of companies:

> (3) 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 paragraph (b) (and any other relevant 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 paragraph (b) above (and any other relevant company[15]) were not resident in the UK.

It is clearly assumed that treaty relief would (but for s.79B) apply to chains of companies.

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15 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."

32.8 DTTs and s.77 TCGA

Section 77(1) TCGA provides, 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 paragraph (b) shall be treated as accruing to the settlor in that year.

Treaty relief is 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[16] in that year of assessment, but
> (b) are non-UK resident at the time of the disposal.

The expression in (b) is 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,—

16 This expression is given a common sense 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."

(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 overrides treaty 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 is 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.

32.9 DTTs and s.86 TCGA

Section 86 TCGA provides:

> **Attribution of gains to settlors with interest in non-resident or dual resident settlements**
> (1) 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;
> (b) the trustees of the settlement fulfil the condition as to residence ...;
> (c) a person who is a settlor in relation to the settlement ("the settlor") is domiciled in the UK at some time in the year and is either resident in the UK during any part of the year or ordinarily resident in the UK during the year;
> (d) at any time during the year the settlor has an interest in the settlement;
> (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[17] ... were made ....

17 The expression is defined in s.86(3) TCGA:
"Where subsection (2)(a) above applies, the assumption as to residence is that the trustees are resident and ordinarily resident in the UK throughout the year; and where subsection (2)(b) above applies, the assumption as to residence is that the double taxation relief arrangements do not apply."

> ...
> (2) 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.
> ...
> (4) 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 was thought to be 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.

32.10 DTTs and s.87 TCGA

DTTs offer no defence to a charge under s.87 TCGA.

CHAPTER THIRTY THREE

EXCLUDED PROPERTY FOR IHT

33.1 Introduction

"Excluded property" is an appropriate term to describe property which is broadly[1] outside the scope of inheritance tax. Sections 6 and 48 IHTA provide the definitions of the term. The reasoning behind the rather complex rules may be better appreciated if the following points are borne in mind.

(1) The starting point is that property situated out of the UK owned by a foreign domiciliary is excluded property.

(2) A separate definition of excluded property is needed for settled property since such property does not have a straightforward beneficial owner. The statute adopts a simple (perhaps too simple) test which is to look at the domicile of the settlor at the time the settlement was made.

(3) The definition is then extended to include gilts and UK AUTs and OEICs with a view (rightly or wrongly) to encouraging investment in these UK assets by foreign domiciliaries.

(4) The scheme of the IHTA is to ignore reversionary interests in settled property and certain other assets. The drafter achieves this with an economy of language by providing that such assets also qualify as excluded property and thus enjoy the benefit of exemptions designed primarily as territorial exemptions.

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1 See 33.15 (Occasions where excluded property is relevant for IHT).

This chapter sets out the rules. The implications for tax planning are discussed at 36.1 (Creating excluded property).

33.2 Non-settled property: general excluded property rule

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.

This is the main category of excluded property.

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 46.1 (Situs of assets).

33.3 Non-settled property: exempt gilts

A second category of excluded property consists of certain British government securities (known as FOTRA securities,[2] and popularly called "exempt gilts"). Exempt gilts are situated in the UK and so cannot qualify as excluded property under the general principle above. 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:

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2 "Free of Tax to Residents Abroad".

- Conversion Stock
- Exchequer Stock
- Index-Linked Treasury Stock
- Treasury Loan
- Treasury Stock
- War Loan

Products issued by National Savings and Investments are not FOTRA securities.

33.3.1 *Conditions for exemption*

The conditions for exemption are not stated in the IHTA. The conditions 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):

> F(No.2)A 1931 s.22(1)
> 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.

> FA 1940 s.60(1)
> 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.

> FA 1996 s.154(1)

> 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.[3]

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[4] 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.[5] ...
> (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[6] and

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3 Prospectuses can be found on *www.dmo.gov.uk/rpt_parameters.aspx?rptCode=D8E&page=about*.

4 "Gilt-edged securities" has the CGT definition: see s.161(6) FA 1998.

5 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".

6 Deemed domicile is irrelevant for this purpose: see 31.7 (When deemed domicile does not matter).

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 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.

33.3.2 *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.[7] 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.[8] Gilts are not in the beneficial

7 Also see "The Origins of Concepts and Expressions used in the OECD Model" [2006] BTR at p.747.

8 *English Sewing Cotton v IRC* [1947] 1 All ER 679.

ownership of an individual if he has entered into a contract to sell them, even a conditional contract.[9]

Gilts subject to put and call options remain in the beneficial ownership of the holder, 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 ownership and, further, insisting that this right of ownership must (with two 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 ownership is said to 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.[10] 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.

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). In Scotland,

9 *Wood Preservation v Prior* 45 TC 112.

10 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 accessible *www.austlii.org* at [25]. Although the context in which the expression "beneficial owner" is used would need to be considered.

> 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 of 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.
> 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).
>
> ...

So far as this discusses English law, the passage is unexceptionable. The part relating to Scotland is unfortunately garbled and I do not know exactly what is intended. It does raise the interesting suggestion that the English authorities set out above would not govern the position in Scotland. I would be grateful to any Scots reader who could direct me to relevant authority.

33.3.3 *Registration*

IHTM04294 provides:

> A FOTRA gilt (IHTM04291) is only excluded property (IHTM04251) if it is included in the list of exempt securities at IHTM04306 (IHTM04306). If it is included then you have to consider who is beneficially entitled (IHTM04031) etc to that security.
> If a worthwhile amount is at stake[11] 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.
> (The 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

11 Understandably, the HMRC view on what is "worthwhile" in this context is not in the public domain.

gilts were registered in the name of the transferor (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 transferor, further proof may be needed to show that the transferor actually is the beneficial owner.

In practice, register the gilts in the name of the transferor or the trustees to avoid possible dispute. Perhaps the withheld text instructs Inspectors how to identify false claims for relief.

33.3.4 *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.

33.3.5 *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).

33.4 Authorised unit trusts and OEICs

Section 6(1A) IHTA provides:

> 6(1A) A holding in an authorised unit trust[12] and a share in an open-ended investment company[13] is excluded property if the person beneficially entitled to it is an individual domiciled outside the UK.

Section 48(3A)IHTA provides the equivalent rule for trust property:

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12 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."

13 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 22.2.4 (Definition of OEIC).

> 48(3A) 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;[14]
> but this subsection is subject to subsection (3B) below.

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. 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) 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 United Kingdom 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.

33.5 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

14 See 33.9 (Purchased interests).

the remittance basis.[15] 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.[16]

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.[17]

33.6 Individual domiciled in Channel Islands or Isle of Man

Section 6(3) IHTA provides a fourth category of excluded property:

> 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.

15 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.

16 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 the UK an unsuitable location.

17 See 2.1 (Policy issues in foreign domiciliary taxation).

The deemed domicile rule does not apply for the purposes of this section: see s.267(2) IHTA.

The IHT Manual correctly states:

> **27270.**
> Other points to note are:
> - 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[18]
> - the exclusion does not extend to settled securities in which there is no interest in possession, i.e. which are held on discretionary trusts
> - the relevant domicile is that of the transferor (and not the transferee) of the securities, at the time of the transfer
> - the deemed domicile provisions of s.267(2) IHTA, do not apply. Accordingly the transferor's domicile has to be determined under general law.

The author is unable to offer any reason for this exemption. It 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 UK IHT net), and

(3) ordinarily resident in the UK (so the ordinary exempt gilts exemption is not available).

33.7 Visiting forces

A fifth category of excluded property is also only mentioned 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.[19]

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18 [Author's note] From 2006 this will now only apply to a recognised IP.

19 For details see s.155 IHTA. There is also a relief under the deemed domicile rules. See 31.6 (Visiting forces).

33.8 Settled property: general excluded property rule

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, and
> (b) section 6(1) above applies to a reversionary interest in the property but does not otherwise apply in relation to the property;
> but this subsection is subject to subsection (3B) below. ...

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.

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.[20] Contrast the IT and CGT position. The identity of the settlor is therefore crucial: see 45.3.5 (IHT definition of "settlor").

Thirdly, the location of the assets comprised in the settlement only matters 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.

33.9 Purchased interests

Section 48(3B) IHTA provides:

> Property is not excluded property by virtue of subsection (3) or (3A) above if—

20 See 33.12 (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.

> (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 United Kingdom, 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) 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).

33.10 Settled property: 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.

33.10.1 *Recognised IP trusts*

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.

That is, a qualifying IP is what this book describes as a recognised IP. The 2006 reforms have (inadvertently?) greatly restricted the scope of this exception.

33.10.2 *Trust without recognised IP*

Section 48(4) 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—
>
> ...
>
> (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**
> Section 48(4)(b) IHTA. 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 - Discretionary trusts and exempt securities: 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 - Discretionary trusts and exempt securities: 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.

33.11 Excluded property and the interest in possession settlement

As we have seen, there are two definitions of excluded property:

(1) "the s.6 definition" defines excluded property for non-settled property.

(2) "the s.48 definition" defines the term for settled property.

Property is either settled or not, so 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 a recognised IP is certainly settled property (so *prima facie* the s.48 definition should apply). However, s.49(1) IHTA provides (for a recognised 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.

So should the property be treated as non-settled property and the s.6 definition be applied?

The answer is provided in part by s.48:

> (3) 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.
>
> (4) 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; ...

Thus 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 a recognised 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 s.48(3) excludes the operation of 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). Section 48(3) excludes s.6(1) so the trust property is excluded property.

An individual domiciled in the Channel Islands or the Isle of Man enjoys a third category of excluded property: see 33.6 (Channel Islands and Isle of Man domicile) above. If such an individual is entitled to a recognised IP in qualifying certificates, the certificates are not excluded property under s.48(4). But 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 must override 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.

33.12 Initial interest of settlor or spouse

33.12.1 *The section 80 fictions*

Special rules apply where the settlor or spouse have an interest in possession in a trust when it is made. 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.
>
> (Paragraphing added)

Thus where the settlor or spouse has an initial IP, s.80 imposes three fictions (“the s.80 fictions”):

(1) It provides an artificial time at which trust property is treated as becoming settled (different from the actual time).

(2) It may provide an artificial person who is treated as the settlor (different from the real settlor).

(3) It may provide that a single settlement is treated as two (or more) separate settlements.

33.12.2 *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 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"—
> (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).

33.12.3 *Spouse with initial IP: excluded property rule*

Suppose:

(1) In Year 1, H creates a trust under which W has a recognised IP.

(2) In Year 2, W dies (so her IP comes to an end).

In this example H is the actual settlor and Year 1 is the actual date of commencement. However, applying the s.80 fictions, the trust is treated as made in Year 2 and W is treated as the settlor.[21]

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 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 settlement actually made by H. (The separate settlement deemed to have been made by W must be the second settlement mentioned in s.80.)

In relation to excluded property, s.82 prevents the s.80 fiction from benefiting the taxpayer. It may however benefit HMRC. Where:

21 It is assumed that H does not become entitled to an IP at the time that W dies.

(1) the settlor's spouse has an initial recognised IP, and subsequently

(2) the settled property is held on trusts where neither of them has an interest in possession,[22]

it is necessary to look at the domicile of the actual settlor at the time when the settlement was actually made *and* at the domicile of the life tenant at the time his or her interest in possession came to an end in order to determine whether the trust property is excluded property. Both must be domiciled out of the UK in order to qualify securely for excluded property status.

33.12.4 *Settlor with initial IP: excluded property rule*

In practice it is unusual for a spouse to have an initial IP (except for will trusts). It is quite common for a settlor to have an initial IP. In these cases, for trusts between 1974 and 2006, s.82 also applies (and the trust property is not excluded property) unless the settlor is non-UK domiciled (1) when the settlement is actually made *and* (2) when his interest comes to an end.[23]

33.12.5 *Planning for partly-excluded property trust*

I use the term "partly-excluded property trust" to refer to a trust where:

(1) the trust property is excluded property on ordinary principles; but

(2) it is not excluded property under s.80/82 rules.

The s.80 and 82 rules apply only for the purposes of "this Chapter": the standard trust regime. They have no wider application. So the property of a partly-excluded property trust:

(1) is not excluded property for the purposes of the standard trust regime; but

22 Whether recognised or unrecognised. This is anomalous, but the drafter of the 2006 rules did not think through the consequences for s.80.

23 Not being followed by another IP for the settlor/spouse.

(2) is excluded property for all other IHT purposes (e.g. GWR and the recognised 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.

33.12.6 *Avoiding s.80 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 to be given to the trust is not UK situate.

33.12.7 *Avoiding s.80 problems: trusts made before 22 March 2006*

In cases where an existing trust confers 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 recognised IP provided that when it comes to an end[24] the life tenant is not UK domiciled or deemed domiciled.

33.12.8 *Postponing s.80 problems*

A partly-excluded property trust should retain a recognised IP for as long as possible. In practice it will 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:

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24 Not being followed by another IP for the settlor/spouse.

(1) a TSI comes to an end (assuming there is no recognised IP);

(2) the IP of the settlor/spouse comes to an end.

33.12.9 *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).[25]

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 section 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.

33.13 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 adds funds to the trust later when UK domiciled.

25 *Dymond's Capital Taxes*, para.19.700.

Can the added property be excluded property? The IHT Manual para 4272 provides:

> **4272. When the settlement was made**
> 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. (IHTM01081)
> *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.[26]

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 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 two separate settlements are deemed to exist where a person adds property to an existing settlement made by him.[27] But since two separate settlements do not exist,[28] one needs something express or implied in the legislation

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26 This view is repeated in RI 166.

27 See para. 34.4 (The separate settlements fiction). If this fiction is applied when there are two settlors, the same fiction could in principle apply when the settlor adds property to his own existing settlement.

28 This is self-evident but if authority is needed see *Truesdale v FCT* (1970) 120 CLR 353 at p362 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

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. 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.[29]

Section 43 IHTA provides:

> (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 with power to make payments out of that income ... or
> (c) charged ... with the payment of any annuity ...
>
> (Emphasis added)

> 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.

29 "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 1655.

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 conforming with *Saunders v Vautier* 4 Beav 115; another would be where there have been separate dispositions to the same trust. So these words do not help the HMRC argument.[30] 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 nonsense of the separate settlements fiction[31] 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 opposite view, that excluded property status depends on domicile of the settlor at the time the property was added.[32]

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30 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.

31 See 34.4 (Separate settlements fiction).

32 See 31.8 (Pre-1974 transitional rules).

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.[33]

However, it may take litigation before HMRC amend their published stance on this issue. 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 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.

33.14 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.

33 *Dymond's Capital Taxes*, para. 30.202.

33.14.1 *Same settlor adds property to company held by trust after acquisition of UK domicile*

If:

(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.

33.15 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 [recognised] 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.

33.16 Works of art

There is a pragmatic Extra-Statutory Concession for works of art:

> **F7 Foreign owned works of art**
> [1] Where a work of art normally kept overseas becomes liable to

> inheritance tax on the owner's death solely because it is physically situated in the UK at the relevant date, the liability will—by concession—be waived if the work was brought into the UK solely for public exhibition, cleaning or restoration.
> [2] The liability will similarly be waived if a work of art which would otherwise have left the UK to be kept overseas is retained in the UK solely for those purposes.
> [3] If the work of art is held by a discretionary trust (or is otherwise comprised in settled property in which there is no interest in possession), the charge to tax arising under s.64 IHTA will, similarly, be waived.

Point [2] was added in 2003. Dawn Primarolo 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.
> Similar disincentives can arise, outside the terms of the existing Concession, when foreign-owned works of art are kept in the UK for these reasons when they would otherwise have been taken elsewhere. That could occur, for example, where a work is already in the UK when it is first acquired by a foreign buyer, and the new owner allows a period of loan to a public collection here before taking it to a permanent home abroad.
> I have therefore agreed that the Concession should be extended to cover such circumstances.[34]

33.17 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 makes a transfer of value, tax shall be charged as if each individual to whom an amount is apportioned under this section had

34 Ministerial Statement 25 February 2003 [2003] STI 303.

> 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) 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.

The IHT Manual extends this exemption to exempt gilts:

> - so much of the company's transfer as is attributable to the value of property outside the UK.
>
> Notify Shares Valuation (IHTM01110) if an outside UK domicile is claimed and ask them to report the relevant figures.
>
> **Foreign company**
>
> 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.
>
> 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.

33.18 Equitable interests in excluded property settlements

33.18.1 *Reversionary interest*

Section 48(3) IHTA[35] 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

35 Set out at 33.8 (Settled property: general excluded property rule).

situate and owned by a foreign domiciliary.

33.18.2 *Interest in possession*

An equitable interest which is a recognised 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.

CHAPTER THIRTY FOUR

IHT CONSEQUENCES OF TRANSFERS BETWEEN TRUSTS

34.1 Introduction

This chapter considers the IHT consequences[1] of transfers between trusts and adding property to trusts. There are three 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: sections 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.

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1 CGT and s.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. This formerly meant discretionary trusts, but it will now include unrecognised IP trusts (from 22 March 2006).

34.2 Trust law background

There are two distinct ways by which property can move between settlements (without a person becoming beneficially entitled to the property in the meantime):

(1) Trustees may exercise a power to transfer trust property to another trust.[3] (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 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.

34.3 General tax principles

The general tax principles are discussed elsewhere.[4] 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.[5]

(2) If a beneficiary with a valuable reversionary interest under trust A

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3 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.

4 See 45.6 (Appointment from old trust to B followed by gift to new trust by B) and 45.7 (Transfer from trust A to trust B by exercise of trustees' power).

5 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.

transfers this interest to trust B, then, at least to the extent of the interest transferred, he is a settlor of trust B.

34.4 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 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; see 33.10 (Settled property: exempt gilts).

The separate settlements fiction is expressed to apply for the purposes of Part 3 of the IHTA (not generally), but all the important provisions which govern trust tax are in Part 3.[6]

The words "and the circumstances so require" show that the drafter was

6 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).

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.

When the separate settlements fiction applies, the settled property is treated as being in separate trusts (which I call "notional trusts"). Unfortunately the statute does not tell us:

(1) what is to be regarded as the trust property of the notional trust;

(2) when the notional trust is to be regarded as made;

(3) who is to be regarded as the settlor of the notional trust.

Context and common sense must fill that gap.

34.5 B adds property to A's trust

Suppose:

(1) an individual ("A") creates a trust ("the real trust"), and

(2) another individual ("B") adds property to it.

The separate settlements fiction applies, and one must imagine that there are two notional trusts. Common sense suggests:

(1) Notional trust A is regarded as if:

- (a) it holds the property given by A;
- (b) it was made at the time A made the real trust; and
- (c) A is its sole settlor.

(2) Notional trust B is regarded as if:

- (a) it holds the property given by B;
- (b) it was made at the time B added property to the real trust; and
- (c) B is its sole settlor.

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 trust). B is a "settlor" in the general tax sense.[7] 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 just about possible though not easy.

34.6 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").

There are then two settlors: an indirect settlor (A) and a direct settlor (B).[8] Both have provided the *same* property.

The IHT analysis is not clear. 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. 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;

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7 See 45.13 (Provision of property for company owned by trust).

8 See 45.4 (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 45.32 (Tax planning to create settlement with foreign domiciled settlor).

(c) was made at the time B created the real trust.

The main difficulty with this analysis is that it leads to double taxation 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 excluded property "unless *the settlor* was domiciled in the UK at the time the settlement was made". A technical argument would be that one cannot say that "the settlor" was domiciled in the UK unless both settlors were domiciled here. No modern court is likely to accept that (least of all in a tax avoidance context). The solution here must surely be to read the word "the settlor" in this context as meaning "the settlor or one of the settlors".[9] In that case the trust property is only excluded property if A and B are both foreign domiciled.

Another possible view is that one should identify A as the "real" settlor and infer that B should not be regarded as a settlor. See 45.4.2 (If A is indirect settlor does B cease to be the settlor?).

34.6.1 *The HMRC view*

RI 166 provides:

> **Several persons contribute to a single settlement**
> ...
> [Section 44(2)] is similar in terms to FA 1975 Sch 5 para 1(8), which 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] [a] 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;

9 Applying (perhaps extending) the rule of construction that the singular includes the plural.

> [b] if such an attribution is not feasible, each separate settlement will comprise all the assets of the single, actual settlement.[10]
>
> **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.
>
> (Paragraphing added)

In practice it is perhaps better to avoid joint settlors (or for one person to add property to a settlement made by another) especially if one settlor is, and the other is not, UK domiciled: this avoids the complication of the separate settlements fiction. But in a straightforward case there should not be any difficulty as long as record keeping is adequate.

34.7 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.

Real trust B then has two settlors (in the general tax sense), A and B. It is suggested that the separate settlements fiction applies and one imagines that there are two notional trusts. Notional trust A is regarded as if:

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10 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.

(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.

Let us see which view makes more sense. The possibilities are as follows:

A is UK domiciled when he made real trust A and dead at the time of the transfer to real trust B. It has been suggested that in these circumstances 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).

Both these propositions are doubtful. 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.[11]

A is UK domiciled when he made real trust A and foreign domiciled at the time of the transfer to real trust B. If I am right that notional trust A is regarded as made at the time that real trust A was made, A's fund cannot become excluded property after the transfer.

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11 This view is also consistent with the principle in *Muir v Muir* [1943] AC 468. 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, it is possible to carry through the fiction and 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; but adopting my approach, s.44(2) gives a sensible result.

A is foreign domiciled when he made real trust A and UK domiciled at the time of the transfer to real trust B. Likewise, if I am right, A's fund need not cease to be excluded property after the transfer.

So it is suggested that wherever A is domiciled at the time he made real trust A, there is in principle no IHT advantage or disadvantage from a transfer to another trust made by B after the death or change of domicile of A.

34.8 Transfer from trust made by A to another trust made by A

Now suppose:

(1) A gives property to trust A1.

(2) A gives property to trust A2 (a separate trust).

(3) 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 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.

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).

34.8.1 *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 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. The transferred property may 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.

34.9 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[12] be treated as remaining comprised in the first settlement.

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. 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.

34.9.1 *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).
> ...
> (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.

12 "This Chapter" is Chapter 3 Part 3 IHTA which deals with relevant property trusts.

Since this 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.

34.9.2 *Transfer from trust made by A to another trust made by A*

Suppose:

(1) A gives property to trust A1.

(2) A gives property to trust A2 (a separate trust).

(3) 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. See above.

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, section 82 prevents the 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.)

In short, for the 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.

34.9.3 *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. See 34.7 (Transfer from trust made by A to trust made by B). At first sight the position for the purposes of RP trust tax seems to be different:

(1) A's fund is treated as remaining comprised in real trust A (applying the same settlement fiction); and

(2) 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.

34.9.4 *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.

34.9.5 *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 *A*, who is domiciled outside the United Kingdom, settles foreign property on discretionary trusts for a short period with remainder to himself. *B* buys *A*'s reversion after 9 December 1981 and settles it on discretionary trusts. 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 had his settlement.[13]

The s.81 fiction would benefit the taxpayer in a situation where the facts are as in 34.9.4 (B transfers equitable interest to another settlement) and:

(1) A is not UK domiciled; and

(2) B is UK domiciled.

Under the general law, B would in principle be the settlor of trust B, but applying the s.81 fiction A would be the settlor! Section 82 counteracts this tax advantage. If my analysis is right at 34.9.3 (Transfer from trust made by A to trust made by B), then s.82 works fairly neatly.

An incidental result is to restrict (but not wholly 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; see 34.9.2 (Transfer from trust made by A to another trust made by A).

34.9.6 *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

13 *Dymond's Capital Taxes*, 19.810.

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.

34.10 Settlor adds property to trust after change of domicile

On this topic see 33.13 (Settlor adds property after change of domicile).

34.11 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 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 THIRTY FIVE

RESERVATION OF BENEFIT

35.1 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.

35.2 The statute

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) There has to be a disposal of property by way of gift. There are three separate elements here; a *disposal*, of *property*, which must be *by way*

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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."

of gift.

(2) Condition (a) or (b) above must be satisfied (a reservation of benefit).

35.3 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.

35.4 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:

> 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 a recognised IP.[2]

35.5 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 only occasionally arise 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".

35.6 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.

35.6.1 *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

2 See 35.16 (GWR on termination of IP).

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 (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 power to add the settlor to the class of beneficiaries.[4]

35.6.2 *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.

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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)".

35.7 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. The reservation of benefit does not affect this charge; just 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 gives no consideration to the IHT which might arise on a gift; it only considers the GWR aspects.

35.8 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 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.

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 section 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 donee or the foreign domiciliary's 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.

35.9 GWR and spouse exemption

On this topic see 41.6 (GWR spouse exemption) and 41.8 (Inter-spouse gift of 100% BPR or APR property).

On a literal construction, an inter-spouse gift of excluded property made by a foreign domiciled individual will fall within the GWR rules. A gift of excluded property is not a transfer of value, so 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 generally, and gifts within s.11 IHTA, are deemed not to be by way of gift.[5]

Such property is nevertheless "subject to a reservation" and so qualifies for the GWR exemption to the pre-owned asset rules.

35.10 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

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5 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.

> property shall be treated for the purposes of the [IHTA] as property to which he was beneficially entitled immediately before his death.

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.

35.11 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.[6]

35.12 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:

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6 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 37.8 (Debt subject to GWR).

> Property situated outside the UK is excluded property if the person beneficially entitled to it is an individual domiciled outside the UK.[7]

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 spouse to a foreign domiciled spouse.[8]

35.12.1 *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.[9]

> ... [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[10]...

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".[11] 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.[12]

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7 Section 6(1) IHTA.

8 See 41.6 (GWR spouse exemption).

9 Lord Asquith, *East End Dwellings Co Ltd v Finsbury Borough Council* [1952] AC 109 at 132.

10 *Marshall v Kerr* 67 TC 56, at p 79A.

11 *Russell v IRC* [1988] STC 195 at p.205.

12 In *Murphy v Ingram* [1973] Ch 363 at 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

35.12.2 *GWR death charge: excluded property rules for non-settled property: 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 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: see 35.13 (Rules for settled property) below).

(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:

> *Example*
> The donor, an Australian, gives Australian shares to his Australian[13] 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 same applies to gifts to companies, including companies held by trusts.

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differently today. For an example see *De Rothschild v Lawrenson* 67 TC 300 at p.316.

13 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.

35.13 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 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?

35.13.1 *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 on 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:

(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".

35.13.2 *The correct solution*

The Non-settled Property Solution has supporters.[14] Nevertheless it was until recently almost universally 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 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.)

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14 "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*.

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.

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 is, 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.[15]

Trustees should bear in mind that even adopting the Settled Property Solution, there will arguably[16] 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) There is UK situated trust property; and

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15 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.

16 See 35.8 (Gift of excluded property).

(2) 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.

35.13.3 *HMRC view(s)*

Until 2001 HMRC agreed with the Settled Property Solution. The former CTO 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.*[17]

Astonishingly, the text was changed (without public announcement) about

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17 *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 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).

October 2001.[18] 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 - Settled property: domicile of the settlor**
> 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 (IHTM04250).

This is not technically accurate,[19] 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 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).
> The property is subject to a reservation and is therefore deemed to be part of the donor's death estate.

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18 The last sentence was changed to read:

> "Any cases where this is the situation must be referred to the Litigation Team."

19 "Property in which the deceased retained an interest" should read "property which is subject to a reservation"; and the GWR property only "forms part of their estate" on death.

> Refer any cases where this is the situation to Litigation (IHTM01083).

The example adopts the Non-settled Property Solution. But the text which follows reverts to the Settled Property Solution: see 35.15 (GWR PET charge).

35.13.4 *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 its mind on points of general importance. The reader may well think that six years since the bombshell in 2001 is long enough to form a considered view.

35.14 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 45.4 (Gift from A to B followed by gift to trust by B).

Now which set of excluded property rules are applied? It is suggested that one must apply the rules applicable to settled property for the reasons given in 35.13 (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).

35.15 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 that when property ceases to be subject to a reservation:

> the donor shall be treated for the purposes of the [IHTA] 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.

35.15.1 *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 suggests 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.

35.15.2 *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.

...

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.*[20]

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 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.

35.16 GWR on termination of interest in possession

Before 22 March 2006, GWR did not usually apply on the termination of an interest in possession, because the termination did not involve a disposal by way of gift. Now s.102ZA FA 1986 provides:

[20] Note these words assume the Settled Property Solution is correct.

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[21] 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 35.13 (GWR death charge: excluded property rules). If the life tenant does not enjoy any GWR, no problem arises. If the views taken in this book, are correct:

(1) The GWR rules do not apply if the GWR property is excluded property.

(2) Adopting the Settled Property Solution, the GWR property is excluded if the settlor was not UK domiciled when the settlement was made, and the trust property was not UK situate at the time of the GWR charge (the death of the former life tenant or the time of cessation of benefit).

21 "the no-longer-possessed property" is defined in subsection (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."

35.17 GWR property subject to debt

Debts are in principle deductible in computing a GWR charge. HMRC accept this. IHT Manual provides at 14401:

> 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)

35.18 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 the argument 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 200 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.[22] 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 the correct answer is, yes.[23] 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[24] to have some right to benefit from all or part of the asset?

The answer would likewise be, yes.

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22 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.

23 The argument that the interest of a beneficiary under a discretionary settlement is not strictly a "right" is fanciful because the context is GWR.

24 In the context this means "continue until death".

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.

CHAPTER THIRTY SIX

IHT PLANNING BY CREATING EXCLUDED PROPERTY

36.1 Basic principles

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. In this way an imminent IHT charge may vanish almost miraculously. 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.

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 should not be UK situate; see 46.4 (Situs of registered shares) and 46.6 (Bearer documents). 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*[1] 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.[2]

36.2 UK situate shares and securities

It is possible to turn UK situate shares and securities into non-UK situate assets for IHT; see 46.6 (Bearer documents).

36.3 Discretionary trusts

A discretionary 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.[3] 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 property.

(2) Immediately after the anniversary they might sell and revert to UK investments.

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1 2 ITELR 794.

2 A gift to the company by way of *donatio mortis causa* solves the CGT problem: section 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.

3 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 35.13 (Discretionary trust: GWR and excluded property rules) and following.

In practice such a course would invite a *Ramsay* attack by HMRC.[4] Ideally the trustees should look for a different strategy such as holding the UK assets in a foreign registered company.

36.4 Interest in possession trusts

Trustees of an interest in possession trust made by a foreign domiciliary may invest in UK property. The property will not be excluded property but there would be no tax charge until the beneficiary's death.[5] If the beneficiary's health begins to fail the trustees could invest in excluded property. Providing they do so before the moment of death – even on the day or hour before death – then there would be no inheritance tax on the death: see 33.8 (Settled property) above.

To convert trust property to excluded property should not be difficult. The trustees may sell it but there is no need to do so. It will be sufficient if they transfer it to a foreign registered company whose shares are held by the trustees. If the trustees are not resident in the UK no CGT arises on the disposal; if the trustees are resident in the UK this will only be a satisfactory solution if the assets qualify for hold-over relief or they do not have inherent gains.

The only inheritance tax risk in this strategy is that the life tenant 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. When the property does not produce income (such as a dwelling house) the trustees may appoint an interest in possession to another person, perhaps an adult child of the beneficiary. The beneficiary may then continue to live in the property with the consent of the child. The child need only be given a revocable interest in the property. The trust law aspects of this proposal would need careful consideration.

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4 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).

5 Or until the death of the beneficiary and spouse, if the spouse exemption applies.

36.5 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.

36.5.1 *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 33.10 (Settled 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.

36.5.2 *UK settlor: foreign domiciled beneficiary*

The best option – if circumstances allow – is 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 tax taint of a UK settlor may then be laid to rest. The beneficiary may after an appropriate period re-settle. This may also be appropriate where the settlor has become foreign domiciled after making the settlement.

36.5.3 *Life tenant domiciled in Channel Islands or Isle of Man but deemed UK domiciled*

For this rare case, see 33.6 (Individual domiciled in Channel Islands or Isle of Man).

CHAPTER THIRTY SEVEN

IHT DEDUCTION FOR DEBTS

37.1 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.

37.2 Liability of individual: outline

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 46.1 (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 8.16 (Interest: where is the source?) and 26.1 (Withholding tax on interest).
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 six 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* James Kessler QC, Key Haven, 5th ed., 2005 para 20.5 (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]

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.

37.3 Section 103 FA 1986

The sixth 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—
> (a) property derived from the deceased; or
> (b) consideration (not being property derived from the deceased)

5 See 37.7 (Debt from life tenant to recognised IP trust).
6 See 37.8 (Debt subject to GWR).

> 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 section 103(1)(a) and (b).

(3) To that extent the consideration is in principle disallowed. (There are defences. I will come to those later.)

37.3.1 *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.
>
> (Paragraphing added)

The IHT Manual gives this simple example at 28365:

> **Example 1**
> On 19 March 1987 A gives his brother B £25,000.

> On 25 April 1987 A borrows back from B £25,000.[7]
> 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 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.

37.3.2 *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.[8] 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-

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7 [Author's Note] It is assumed that this £25,000 is, or represents, the £25,000 given to B.

8 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.[9] But this arrangement is caught by s.103(1)(b) FA 1986 and the liability is not an allowable deduction for IHT purposes.

37.3.3 *The section 103(2) defences to section 103(1)(b)*

Section 103(2) offers defences to the section 103(1)(b) disallowance.[10] 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.

37.3.4 *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].

9 [Author's Note] It is assumed that the £25,000 which B lends to A does not represent the land.

10 Section 103(2) does not override the section 103(1)(a) disallowance.

The IHT Manual gives a simple example:

> **IHTM28369 - Investigating form D16: 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][11] 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.

37.3.5 *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:

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11 The IHT Manual erroneously reads: deceased.

> 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.

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 this amount is the excess consideration.

37.3.6 *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.

37.3.7 *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[12] 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

12 That is, the disposition made by the deceased. See 37.3.1 (s.103(1)(a) disallowance).

arrangement with any other person, otherwise than for full 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.

(Paragraphing added)

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 recognised 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.

37.3.8 *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.[13]

37.3.9 *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

13 See 35.15 (GWR PET charge).

"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 includes consideration for the assignment of the debt.

37.3.10 *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…

37.4 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.

37.5 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.

37.5.1 *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.

37.5.2 *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 ss.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 - Law relating to debts: 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.

37.5.3 *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.[14] The IHT Manual shows that HMRC broadly accept this:

> **28396 - Law relating to debts: 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
> · *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.

37.5.4 *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.

37.6 Planning: individual[15] borrows and acquires excluded property

Suppose F is not UK domiciled and owns UK situate property worth £1 million. He faces an IHT charge on that amount on his death.

F borrows £1 million 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

14 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.

15 See also 37.11 (Trustees borrow and acquire excluded property).

death of F.[16]

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.

37.7 Debt from life tenant to recognised IP trust

37.7.1 *Debt owed by non-settlor life tenant to trust*

Suppose trustees lend money to the life tenant (not the settlor) of a recognised 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.

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16 Except so far as property prices rise.

Robert Venables QC disagrees. He cites section 49(1) IHTA and Lord Asquith's familiar dictum in *East End Dwellings v Finsbury Borough Council* [1952] AC 109[17] and continues:

> If one applies Lord Asquith's dictum, what is deemed to happen when the settlor[18] 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 money borrowed, as a man cannot have a right against himself.[19]

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.

37.7.2 *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,[20] 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 paragraph 37.7.1 above, the debt and the asset of the trust cancel each other out and both are ignored. This is a sensible

17 These are set out in 33.11 and 35.12.1 respectively.

18 Venables is considering the position of a settlor life tenant but the same applies to a non-settlor life tenant.

19 "An IHT Trap for Settlors of Non-UK Resident Trusts", Robert Venables QC, OTPR, vol 4, issue 3, p.165.

20 But this would not often apply to excluded property trusts or to trusts where the settlor has an initial recognised IP: see 37.3.7 (The s.103(4) defence).

result, which fits the purpose of the legislation. In practice HMRC appear to accept this.

37.8 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,[21] 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 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.[22]

37.9 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

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21 See 37.3.7 (The s.103(4) defence).

22 As to whether the GWR debt is subject to IHT under the GWR rules, see 35.11 (GWR over debt owed by the deceased).

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.

37.10 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*.
>
> (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.[23] 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

23 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.

on the death of the life tenant and in computing ten year and exit charges.[24] This is the correct reason why trustee liabilities are allowable.[25] 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 as we are not concerned with a debt or disposition made by the individual.

37.10.1 *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 charged on specific trust property, the deduction is set against that property: s.162(4) IHTA.

(2) If the liability is not charged 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

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24 Note s.65(5) IHTA assumes liabilities are deductible.

25 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).

payment and residence of creditor are not relevant, and s.162(5) IHTA does not apply.

37.11 Planning: trustees[26] borrow and acquire excluded property

37.11.1 *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 £1 million. The trustees face an IHT charge on that amount on his death.

The trustees borrow £1 million 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.[27]

Alternatively, the sum borrowed may be advanced to a (foreign domiciled) beneficiary. Watch Schedule 4A TCGA.

37.11.2 *UK domiciled settlor but foreign domiciled beneficiary*

Suppose T is the life tenant under a trust made by a UK domiciliary. Trust 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 £1 million 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 £1 million. 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.

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26 See also 37.6 (Individual borrows and acquires excluded property).

27 Except so far as property prices increase.

37.12 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 - Funeral expenses: 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.

CHAPTER THIRTY EIGHT

IHT PLANNING BEFORE AND AFTER A CHANGE OF DOMICILE

38.1 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.

38.1.1 *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 fifteen to seventeen years' residence here: see 31.2 (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 31.9 (Tax planning for the deemed domiciliary).

38.1.2 *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 ? (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).

38.2 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 36.1 (IHT planning by creating excluded property).

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

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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 33.12 (Initial interest of settlor or spouse).

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 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.

38.3 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 34.8 (Transfer from trust made by A to another trust made by A).

A third-best solution involves loans: see 37.11 (Borrowing by trustees and acquisition of excluded property).

CHAPTER THIRTY NINE

IHT ON DEATH: WILLS AND IOVs

39.1 Will drafting: general strategy

There has always been considerable scope for tax saving through a carefully drafted Will.

39.1.1 *Foreign domiciled testator: UK domiciled beneficiaries*

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.

39.1.2 *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.

39.2 IHT spouse[1] exemption

Section 18 IHTA provides:

> (1) A transfer of value is an exempt transfer to the extent that the value transferred is

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1 References to spouse, marriage, and widow/ers include a civil partner, civil partnership and a surviving civil partner. See 1.2 (Meaning of spouse) and 1.3 (Civil partners).

[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.
(2) 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 ... shall not exceed £55,000 less any amount previously taken into account for the purposes of the exemption conferred by this section.[2]

(Paragraphing added)

I refer to this as the IHT spouse exemption.

39.3 IHT spouse exemption on death of a foreign domiciliary

Suppose:

(1) H (not UK domiciled) dies leaving:
  (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. Section 4, 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. ...

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2 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*, James Kessler QC, Key Haven Publications (5th ed., 2005).

3 By will, by survivorship or by the relevant succession law; this makes no difference.

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").

(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]
>
> (Paragraphing added)

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

4 In the case considered here the restriction in section 18(2) does not apply since H (the transferor) is not domiciled in the UK.

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 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 advisers.

Now suppose H leaves W a pecuniary legacy. The IHT Manual provides at IHTM11013 (March 2005):

> 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 (IHTM01081).

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 provides that these rules apply where (*inter*

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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.

7 The end result is consistent with the exemption for funeral expenses, which are set against UK property alone; see 37.12 (Deduction for funeral expenses).

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) provides that:

> Such part of the value transferred shall be attributable to specific gifts as corresponds to the value of the gifts …

This confirms the view taken above.

39.4 Drafting will of foreign domiciliary

39.4.1 *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 strategy 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 2 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 2 years. But the only cost is the cost of the deed of appointment.

39.4.2 *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.

39.5 Instruments of variation ("IOVs")

The IHT Manual provides:

> **35094 - Property redirected to the spouse: 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 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.)

39.6 IHT account on death of foreign domiciliary

See 48.2 (Reporting requirements on death of foreign domiciled individual).

8 It would be different if there was an arrangement under which the spouse later swapped the UK property for the excluded property.

CHAPTER FORTY

IHT DOUBLE TAX RELIEFS

40.1 Introduction

This chapter considers pre-1975 double tax treaties for IHT. There are four treaties: India, Pakistan, Italy and France. They are similar but not identical. I do not consider post-1975 treaties, though I hope to do so in a later edition.

The treaties are important to those who are deemed domiciled in the UK, but treaty-domiciled in India, Pakistan, Italy or France.

40.2 Application of treaties to IHT

India DTT article 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 United Kingdom, 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.[1]

The treaty refers to UK estate duty, a predecessor of IHT, but it is extended to IHT by s.158(6) IHTA:

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1 India DTT article 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.

> 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 tax[2] chargeable by virtue of section 4 above; ...[3]

The Pakistan, Italy and France DTTs are substantially the same: see articles I and II of each DTT.

40.3 Treaty IHT exemption

India DTT article 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

2 The reference to CTT has effect as a reference to IHT: s.100 FA 1986.

3 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 paragraph (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.

> 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 article V(1) provides:

> Where a person was at the time of his death domiciled in some part of 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 article 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-paragraph (a) or (b) shall be disregarded.

I refer to this as treaty IHT exemption.

The exemption only applies to duty imposed on a death. That includes the charge which applies on property in the individual's free estate, property in a recognised 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 seven 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 treaties give rise to many other anomalies. There is no relief on ten year charges on trusts. There is no relief on a lifetime chargeable transfer, such as a gift to a trust.

40.3.1 *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.

40.4 Domicile requirements of treaty IHT exemption

40.4.1 *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-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.

40.4.2 *Domicile in treaty state*

The requirement for IHT exemption in each treaty is 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.

40.4.3 *Treaty-domicile: India and Pakistan*

India DTT article 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 article 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.[4]

40.4.4 *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 when it matters, 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;

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4 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'."

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.

(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 tiebreaker in the OECD Model Convention definition of residence, art.4(2) and reference should be made to the OECD Commentary.[5] France is the same as Italy: France DTT article II(3). A key question is what is required for a person to be domiciled in Italy under Italian law.

40.5 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.

40.5.1 *Treaty situs rules: India, Pakistan, Italy*

India DTT article IV(1) provides:

> Subject to paragraph (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 Article VI, be determined exclusively in accordance with the rules in Article V of the present

5 There is also a discussion in the third edition of this book, para.17.16.

Agreement.

However there is a condition in art.IV(2):

> Paragraph (1) of this Article shall apply if, and only if, apart from the said Article V—
> (a) duty would be imposed on the property under the law of each of the Contracting Governments; or
> (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. One wonders why the treaties have survived more than two decades after losing their *raison d'être.*

Italy is substantially the same: Italy DTT article 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.

40.5.2 *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 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 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*;[6]

(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.*

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6 i.e. torts, not contractual rights.

40.6 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, 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.

40.7 Unilateral relief

Section 159 IHTA provides:

> **159 Unilateral relief**
> (1) Where the Board are satisfied that in any territory outside the United Kingdom (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.
> (2) Where the property is situated in the overseas territory and not in the United Kingdom, the credit shall be of an amount equal to the overseas tax.
> (3) Where the property—
> (a) is situated neither in the United Kingdom nor in the overseas

territory, or

(b) is situated both in the United Kingdom 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.

(4) Where tax is imposed in two or more overseas territories in respect of property which—

(a) is situated neither in the United Kingdom nor in any of those territories, or

(b) is situated both in the United Kingdom 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.

(5) 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.

(6) 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.

(7) Where relief can be given both under this section and under section 158 above, relief shall be given under whichever section provides the greater relief.

The IHT Manual provides some examples:

27185. Introduction

We can allow credit under Section 159 IHTA 1984 for tax paid this is called "unilateral" relief. 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.

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.(IHTM01081)

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.

SV (Foreign) (IHTM01110) 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.

…

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.

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.

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.

27188. Relief under Section 159(3) and Section 159(4) IHTA 1984

- 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 United Kingdom nor in the foreign country, or
- both in the United Kingdom 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 amount of the credit is found by the formula

$$\frac{A}{A+B} x C$$

where:

A is the amount of Inheritance Tax due

B is the amount of the foreign tax

C is the smaller of A and B

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

Where tax is imposed on the same property by two or more foreign countries and the property is situate:

(a) neither in the United Kingdom nor in any of those foreign countries, or

(b) both in the United Kingdom and in each of those foreign countries.

relief is due under Section 159(4) IHTA 1984. The formula,

$$\frac{A}{A+B} x C$$

applies where

- A is the amount of Inheritance Tax
- B is the aggregate amount of the foreign tax imposed in each of the foreign countries
- C is the aggregate of A and B, except the largest amount of tax paid in either A or one of the foreign countries is left out of the sum

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

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. (IHTM01081)

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)

…

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.

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).

CHAPTER FORTY ONE

UK DOMICILIARY MARRIED TO FOREIGN DOMICILIARY

41.1 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.

41.2 Restriction on IHT spouse exemption for foreign domiciled spouse

Section 18(1) IHTA normally provides complete exemption for transfers between spouses; see 39.2 (IHT spouse exemption). 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

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1 References to spouse, marriage, and widow/ers include a civil partner, civil partnership and a surviving civil partner. See 1.2 (Meaning of spouse) and 1.3 (Civil partners).

(2) the transferee (the spouse of the transferor) is foreign domiciled

the exemption is restricted to £55,000 only.[2] 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[3].

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 under s.267 IHTA: see 31.2 (Deemed UK domicile).

41.2.1 *Interaction of £55,000 spouse exemption and other exemptions*

An inter-spouse gift within the £55,000 limit is *not* a PET. Section 3A(1A)(b) IHTA provides that a PET is a transfer of value "which, apart from this section, would be a chargeable transfer".[4] So if one spouse

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2 The IHT Manual states at IHTM11033 (February 2006):

"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 (IHTM225130), agricultural relief (IHTM24001) or other reliefs."

3 See the UK/USA IHT DTT art.8.

4 Transfers before 22 March 2006 are governed by s.3A(1) IHTA but the wording on this point is the same.

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.[5] 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.

41.3 Application of IHT spouse exemption on death and will drafting

On these topics see 39.3 (IHT spouse exemption on death of a foreign domiciliary) and 39.4 (Will drafting).

41.4 Exemption when spouse or widow of settlor becomes entitled to settled property

The termination of a recognised 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 section 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.[6]

This relief only applies if the spouse is UK domiciled. The restriction on s.53(4) relief is broadly consistent with the restriction to the spouse

5 Likewise a gift within s.11 IHTA; see 41.5 (Disposition for maintenance of spouse).

6 Section 53 goes on to set out some exceptions not discussed here.

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 interest in possession on the death of the life tenant.

41.5 Disposition for maintenance of spouse

Where the 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[7] or civil partnership in favour of the other party ... and is—
> (a) for the maintenance of the other party ...[8]

This should normally[9] 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.[10] In *Phizackerley v IRC*[11] 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)

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7 Marriage is defined to include a former marriage in certain cases: s.11(6) IHTA.

8 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).

9 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.

10 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).

11 [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.)[12]

41.6 GWR spouse exemption

The GWR rules[13] do not generally apply on gifts between spouses. Section 102(5) FA 1986 provides relief:

> 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) ... ;

I refer to this as the GWR spouse exemption. Where a UK domiciled individual makes a gift to a foreign domiciled spouse, the 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.[14]

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.

When a foreign domiciled individual makes a gift of excluded property to his spouse, the IHT and GWR spouse exemptions do not apply; but such gifts are outside the scope of GWR; see 35.8 (Gift of excluded property).

41.7 IHT spouse exemption defence to GWR charge on death

Suppose H (UK domiciled) makes a gift to W (foreign domiciled at the

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12 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.

13 See 35.1 (Reservation of benefit).

14 Such as the family maintenance exemption: see 41.5 (Disposition for maintenance of spouse).

time of the gift).[15] 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. Accordingly the gifted property is subject to a reservation and hereafter called "GWR property". On the death of H the position 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 W is foreign domiciled at the time of the death of H).[16] So H will in principle be subject to inheritance tax on the property on his death.

The interesting question is whether the spouse exemption is available on the death of H to avoid the 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.

It is considered that the spouse exemption would apply if the facts are as set out above, and, in addition:

(1) W still owns the GWR property at the time of the death of H; and

(2) W has become UK domiciled (or deemed domiciled) at the time of the death of H.

At first glance it might seem that the spouse exemption does not apply.

On the facts of this example the conditions of the relief are not in reality satisfied. The GWR property subject to the reservation 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

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15 The gift is a PET (but assume H survives seven years so no tax charge arises on the PET).

16 See 35.12 (Non-settled GWR: excluded property rules on death of donor).

remember that s.102(3) FA 1986 is a deeming provision. It is the old question of how far one carries the deeming.[17] 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 spouse exemption would also apply to defeat a GWR charge if H made a gift to a trust under which his spouse acquired an 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.

41.7.1 *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 41.14.2 (Gift to foreign domiciled spouse, followed by settlement by spouse).

41.8 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 spouse to a non-UK

17 See 35.12.1 (Construction of deeming provisions).

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.

41.8.1 *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 section 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.)

41.8.2 *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.

41.8.3 *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[18] 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. 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.

41.9 Other relevant exemptions

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.

41.10 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.[19]

No IHT charge arises. First, the disposition is not a transfer of value, if made under Court Order.[20] 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—

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18 Though there is a possibility of reinvestment relief in this case: see s.113B IHTA.

19 This may be because H is UK domiciled and W is not; or because the transfer is made after the marriage is dissolved.

20 See *McCutcheon on IHT*, 4th ed, para.2.54. Relief may also be available under s.11 IHTA; see 41.5 (Disposition for maintenance of spouse).

> (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 section 10 IHTA and is not a transfer of value for IHT purposes.

There is a theoretical HMRC argument that the condition in section 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 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.[21]

41.11 Payments into and out of a joint account

41.11.1 *Introduction*

This section considers a joint bank or building society account held by spouses of whom one is, and one is not, UK domiciled. One could write a thesis on this intriguing topic. Similar problems arise for joint accounts of cohabitees. Few problems arise if both spouses are (or both are not) UK domiciled because transfers between them qualify for the spouse exemption. Related problems arise for joint accounts held by parent and child, but the circumstances in which these joint accounts arise are different so the rights of the parties may be materially different.

There is an important distinction between:

(1) an account on which either husband or wife can draw a cheque;

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21 IHTM 4165: "Dispositions made on divorce or dissolution of a civil partnership 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."

(2) an account on which both husband and wife must sign a cheque.

This book only considers the first type of account.

41.11.2 *The banking law background*

First of all one must ascertain the rights of the joint holders of the bank account. It would need a chapter to analyse the relevant case law,[22] but the starting point if English law applies[23] is *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.

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22 For a summary see *Dymond's Capital Taxes*, para. 10.400.

23 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.

I refer to this as a *Bishop* account. This may be displaced by a contrary intention of the spouses. The possibilities include the following:

(1) The funds in the account 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 funds pass to W by survivorship;[24] or
   (b) the funds may pass under the Will of H.
   Either way, the IHT position is straightforward.

(2) The funds in the account may belong to the account holders on terms that:
   (a) each holder may make a withdrawal from his or her share (and the amount of his or her share is altered accordingly); and
   (b) the beneficial ownership of the funds pass under the Will of each account holder.
   In practice the Court will assume this is not the case unless there is good evidence, such as appropriate records kept by the account holders. Where this is the case the IHT position is again straightforward.[25]

(3) 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 survivors by survivorship.
   In this case the fund is in the estate of P for IHT purposes: s.5(2) IHTA.[26] The funds are not in the estate of the other holders during the life of P: their rights have no substantial value.

This enumeration is by no means comprehensive. The possibilities are almost endless. Note that joint tenancy/tenancy in common is not a

24 The apparent breach of the Wills Act 1837 is tacitly ignored.

25 John Avery Jones gives cogent reasons for rejecting this analysis to the parent/child account in *Sillars v IRC* [2004] STC (SCD) 180, para. 11.

26 This was found to be the case on the facts in *Sillars v IRC* (above) in which, however, the taxpayer was not represented by Counsel. The last part of the decision, that the GWR rule applies, is obiter and doubtful.

comprehensive categorisation since it ignores the important question of rights over the fund during the lifetime of the account holders.

In practice spouses generally operate joint accounts without giving any consideration to the ownership of the money, a search for intention is unrealistic, and the *Bishop* analysis applies.

41.11.3 *HMRC practice*

HMRC practice (or some of it) is set out in the IHT Manual:

> **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 (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.52 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 . 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. You should also avoid questions and arguments on this subject unless the amount of tax at stake is substantial. 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)

15043 - The extent of the claim (England, Wales and Northern Ireland): lifetime gifts arising out of a transfer of an account into joint names
[June 2005]
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 (IHTM01081) 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)

41.11.4 *What is the official secret?*

Under the Freedom of Information Act the Government can withhold information whose disclosure would be likely to prejudice the assessment or collection of tax.[27] It is amazing that something as innocuous as the operation of a joint account should fall within this category.

What is it that HMRC do not want us to know? The author guesses that the withheld text makes the following points. In strictness both holders of a *Bishop* account are taxed on the basis that the whole of the joint account is in the estate of both.[28] However, that result is so absurd HMRC cannot enforce it (and the Courts would strive to reach a different result if they tried, difficult though this would be). In consequence HMRC operate an unpublished concession, the boundaries of which are not defined, giving them a wide discretion to attack joint account arrangements which differ in any respect from *Bishop* accounts or where

27 s.31 Freedom of Information Act 2000.
28 This was accepted without discussion in *IRC v Melville* 74 TC 372.

there has been an element of IHT avoidance.[29]

Payment into a *Bishop* account is not a disposal by way of gift so the GWR rule does not apply.

41.11.5 *Planning implications*

Joints accounts should not be used for IHT planning. Ideally substantial sums should not be put in joint accounts at all (except where the account holders are married and qualify for the full IHT exemption). An alternative would 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.

41.12 Account governed by Scots law

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

29 See e.g. *O'Neill v IRC* [1998] STC (SCD) 110 and *Sillars* (*supra*).

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

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 (IHTM01081).

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 (Section 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

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 Section 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.

41.13 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.

41.14 IHT planning for mixed marriage

41.14.1 *Simple gift to foreign domiciled spouse*

A simple and obvious short and medium term strategy 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 41.7 (Spouse exemption defence to GWR charge on death). This often makes simple gifts impractical.

41.14.2 *Gift to foreign domiciled spouse, followed by settlement by spouse*

A more sophisticated IHT strategy 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 38.1 (IHT planning in anticipation of acquiring UK domicile). Another advantage is CGT planning: see 29.14 (CGT planning before acquisition of asset or trade). 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 45.32 (Tax planning to create settlement with foreign domiciled settlor).

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30 See 35.14 (Gift to foreign domiciled donee who creates a settlement).

41.15 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.

The transfer has quirky consequences for CGT taper relief: see TCGA Schedule A1 para.15.

41.16 CGT planning for mixed marriage

41.16.1 *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 CGT strategy 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 29.1 (CGT on individuals).

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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 41.2 (Restriction on IHT spouse exemption for foreign domiciled spouse) and 41.6 (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.

Watch *Furniss v Dawson*!

41.16.2 *Gift to foreign domiciled spouse followed by company or settlement by spouse*

A more sophisticated CGT strategy is:

(1) The UK domiciled spouse transfers[32] the asset to his foreign domiciled spouse.

(2) The foreign domiciled spouse then gives the asset to a trust.

This offers the CGT advantages discussed in 29.13 (CGT planning before disposal of foreign situate asset). The problems discussed in 41.14 (IHT planning for mixed marriage) arise. If the object is CGT planning and not long term IHT planning, a better planning strategy here may be:

(1) The UK domiciled spouse transfers the asset to his foreign domiciled spouse.

(2) The foreign domiciled spouse acquires a non-resident company.

(3) The foreign domiciled spouse gives the asset to that company.

There is no trust, so no issue of "who is a settlor" arises. Take great care that the company can be proven to be non-resident!

41.16.3 *Asset yielding a loss*

The opposite point arises if the foreign domiciled spouse owns a foreign situate asset which will give rise to a loss. The loss on the disposal will not be allowable. See 29.18.2 (Loss on disposal by foreign domiciliary). Suppose:

(1) The foreign domiciled spouse transfers the asset to his UK domiciled spouse.

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32 See above footnote.

(2) The UK domiciled spouse disposes of the asset.

In principle the UK domiciled spouse realises 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.

Tax advantage is defined in a familiar way in s.16A(2):

> "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 as follows. An allowable loss is a relief and so a "tax advantage." So if one of the main purposes of the transfer is to obtain the loss, the loss is disallowed. Of course it depends on the precise facts whether that is actually so, but in many cases it would be so.

However, HMRC say:

> 15. Nothing in the new legislation prevents relief for losses under section 24 where a genuine loss has been incurred on an asset which has been lost or extinguished, etc., or where an asset has genuinely become of negligible value. 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].[33]
>
> (Emphasis added)

According to this, section 16A does not apply to genuine losses, and the loss in the case under discussion is genuine.[34]

The first question this raises is: what is meant by genuine loss and why is the loss in this case 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/evasion distinction.[35] A loss is genuine

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33 Avoidance of tax through the creation and use of capital losses: HMRC Guidance 1 May 2007.

34 The Guidance Note provides:

> "Example - sale of shares to realise capital loss
>
> 38. 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. 39. 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 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."

35 See 19.18.3 (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.

The guidance 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".

The next difficulty is to reconcile that approach 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,[36] when it is strongly arguable that they are caught.[37]

If that is right, then the real decision whether or not to apply the legislation is in many cases made by HMRC with no redress by the taxpayer (for judicial review is not likely to be successful except in very gross cases). However, it is suggested, having regard to *Pepper v Hart*, that the reference to tax advantage should be read so as to mean tax avoidance in the strict sense. The fact that the definition here is based on words in other sections which have been understood differently[38] does not determine the issue.

The reader may wonder whether this discussion matters, given that the HMRC practice is known. On a constitutional level it matters to those who think that tax should be based on law and not concession. On a practical level it matters if HMRC later decide to change their practice

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36 Section 16A was introduced with the tendentious title of *targeted* anti-avoidance rule.

37 Response of CIOT to consultation (8 February 2007).

38 See 19.15 (Subsidiary consequence not necessarily a purpose)

(which as the IR20 debacle shows is not a theoretical possibility) or if they chose to apply it inconsistently.[39]

41.16.4 *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 accepts 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.

41.17 Income tax planning for mixed marriage

A simple and obvious strategy 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:

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39 Guidance Note para 24 is intended to give HMRC freedom to more or less disregard their own guidance note:

> 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.

> (4) In this Chapter references to individuals include their spouses or civil partners.

However, RI 201 provides relief:[40]

> 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 section 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—
> (a) it is subject to conditions, or
> (b) there are any circumstances in which the property, or any related property[41]—
> (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.

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40 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 that the same practice (obviously) applies to civil partners.

41 s.626(5) ITTOIA provides that:

> "'Related property' has the same meaning in this section as in section 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 FORTY TWO

THE FAMILY HOME AND ITS CHATTELS

42.1 Ownership 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: see 39.2 (IHT spouse exemption).

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[1] (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 46.18 (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.

Take care to avoid 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.

42.2 Direct ownership by non-resident recognised IP trust

This avoids a CGT charge on a disposal, 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.

This also 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 is only practical, however, for recognised 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; see 35.8 (Gift of excluded property).

42.3 Direct ownership by discretionary trust

In principle a discretionary trust or unrecognised 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 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; see 35.8 (Gift of excluded property).

42.4 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: see 37.1 (IHT deduction for debts). Commercial borrowing is likely to be an expensive solution to the IHT problem but borrowing from a friendly trust may be practical.

42.5 Ownership by non-resident company: IHT advantages and sham

For inheritance tax, the obvious strategy 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 nominee) to avoid a benefit in kind charge.

42.6 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. This does not apply if the individual is not UK domiciled. (In the case of a UK domiciled individual, it is an interesting question whether private residence relief could apply to give exemption to the s.13 charge.)

If the company is held by a trust, the gains would be "trust gains". Again, this is not a problem so far as capital payments from the trust are received only by foreign domiciled or non-resident beneficiaries.

42.7 Family home held by company: benefit in kind charge[2]

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".

42.8 Some defined terms

The provisions swarm with defined terms. Several of the terms are misleading in that they do not carry anything like their natural meaning,

2 The EI Manual contains much interesting material on these provisions which cannot be set out here for lack of space.

so the effective tax charge is different from what it might appear to be.

42.8.1 *"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 ...[3]

42.8.2 *"Family" and "household"*

The definitions are in s.721 ITEPA:

> (4) 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). 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. Section 721(5) provides:

> 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.

3 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.

42.8.3 *"Employer", "employee" and "employment"*

Section 5 ITEPA extends the concept of "employment" to include officers (e.g. directors who may not as a matter of employment law be employees). This provides:

> **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.

42.9 "Provided": available or used

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 Section 145 ICTA 1988. (Section 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**
> 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 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
[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 Section 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 Section 106. This would mean that the cash equivalent for the tax year would be £15,600 (£500 × 26 + £100 × 26). Under Section 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
[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 Section 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 Section 106. This would mean that the cash equivalent for the tax year would be £1,200 (£15,600 × 4/52). Under Section 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 Section 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 Section 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

[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.

42.10 Shadow directors: HMRC practice

The House of Lords decided in *R v Dimsey & Allen* 74 TC 263 that the benefit in kind provisions apply to shadow directors.[4] The reasoning continues to apply under ITEPA. The charge is monstrously unfair to a shadow director who does no work for the company. Income tax is meant to 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

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4 This reversed an unreported Special Commissioners' decision which held 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*.

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 law) works up to a point. Taxpayers cannot afford to carry out their planning on the assumption that HMRC's benign neglect of the provisions will apply to them.

42.11 The cash equivalent: ss.105 and 106 computations

The charge is on the "cash equivalent". Section 103 ITEPA explains:

> **Method of calculating cash equivalent**
> (1) The cash equivalent is calculated—
> (a) under section 105 if the cost of providing the living accommodation does not exceed £75,000; and
> (b) under section 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 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.

42.12 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[5] 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

5 For the exception see 42.15 (Revaluation).

In short, *A* is **A**cquisition cost, *I* is **I**mprovement cost, and *P* is **P**ayments received in return. 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,[6]
> *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. 42.20 (Purchase financed by foreign domiciliary).

42.13 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 attributable to its provision.

6 The expression "person involved in providing the accommodation" is defined in s.112 ITEPA.

The key concepts are "rental value of the accommodation" and "making good" and I deal with these in turn.

42.13.1 "*Rental value of the accommodation*"

Section 105 provides:

> (3) The "rental value of the accommodation" for the taxable period is 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) But if the person at whose cost the accommodation is provided pays rent for the whole or part of the taxable period at an annual rate greater than the annual value—
>
> (a) subsection (3) does not apply to that period or (as the case may be) that part of it; and
>
> (b) instead the "rental value of the accommodation" for that period or part is the rent payable for it by that person.
>
> (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.[7]

The EI Manual provides at para 11434:

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7 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."

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.[8]

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:

(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

8 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."

express all this in ITEPA. The rules are incoherent.

42.13.2 *"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 withdheld because of exemptions in the Freedom of Information Act 2000)**[9]
> 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

(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

9 [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.

the building is probably not a "sum" made good. HMRC Manual is equivocal:

> **11439. Living accommodation: annual value of UK property: Employee responsible for repairs or insurance.**
> ...
> An employee may be responsible for the cost of repairs or insurance under the terms of his or her lease or employment. 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 Section 110 ITEPA, make a full report to Personal Tax (Technical), Solihull.

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.

42.13.3 *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.
> 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.

42.14 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 section 105 applied (cash equivalent: cost of accommodation not over £75,000).

See para 42.13 (Section 105 computation).

Step 2 Calculate the following amount ("the additional yearly rent")—
ORI × (C – £75,000)
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 section 104 (general rule for calculating cost of accommodation),[10] or
(b) in a case where section 107 applies (special rule for calculating cost of providing accommodation), in accordance with that section instead.[11]

The label "additional yearly rent" is misleading: the "additional yearly 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.

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10 See 42.12 (Cost of providing accommodation).
11 See 42.15 (Revaluation in cases of delayed occupation).

(3) In step 4—
 (a) paragraph (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 section 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) (what I call) the s.106 computation (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.[12]

42.15 Revaluation 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 section 106(2)

12 I do not understand the point of the last sentence, for if the additional yearly rent is disregarded, the "excess rent" is irrelevant.

(calculating the additional yearly rent), and

(b) accordingly only operates where the cost of provision for the purposes of section 106(1) (as calculated under section 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—

$$MV + I - P$$

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.

42.16 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 Section 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 Section 108 the cash equivalent of the benefit of the living accommodation provided to each employee would be 80% of the whole house. However Section 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 Section 108 being relevant in a family situation see example EIM11421.

42.17 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.

I will consider these in turn.

42.18 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".[13]

In *Secretary of State for Trade and Industry v Deverell* Morritt LJ comments on this in numbered paragraphs:[14]

> (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 professional advisers, with real influence in the corporate affairs of the company.

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13 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.

14 [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).

This paraphrase does not take us very far because it only raises the question as to what is meant by "real[15] 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.

This at least is correct.[16]

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15 The dangerous and beguiling word "real" is normally an indicator of vague if not sloppy legal analysis.

16 For other examples of the "label" doctrine, see *Drafting Trusts and Will Trusts*, James Kessler QC, Sweet & Maxwell, 7th ed., para.18.3.

> (4) Non-professional advice may come within that statutory description. The proviso excepting advice given in a professional capacity[17] 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.[18]

> Moreover the concepts of "direction" and "instruction" do not exclude the concept of "advice" for all three share the common feature of "guidance".

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

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17 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."

18 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."

> 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 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* [2005] EWHC 1638:

> 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.[19] This is wholly unjustified for the reason set out in *Ultraframe*.

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19 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".

Suppose a person treats the property owned by the company as his own 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".

42.18.1 *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).[20] 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.

42.18.2 *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

20 See the 5th edition of this book, para.5.6.2.

(2) the trustees transfer the property to a foreign company on their own initiative and without reference to the occupier.

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.[21] SDLT makes this impractical 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.

42.19 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).

21 I am grateful to Peter Vaines for this suggestion.

42.19.1 *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.

42.20 Property purchase financed by the foreign domiciliary

Sometimes a company structure is set up specifically for the purpose of purchasing the home. That is, under a pre-organised arrangement:

(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 a background of this kind offers a defence to the benefit in kind charge.

42.20.1 *"Making good" and s.105 computation*

The section 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 foregone 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.[22]

Whether the interest foregone "makes good" the provision of accommodation is a question of fact. Assuming the reason the interest is foregone is to enable the company to provide the accommodation, this condition should be satisfied.

Whether the interest foregone 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 foregone may be a "sum".[23] See 42.13.2 ("Making good": meaning).

42.20.2 *Loan to company as defence to section 106 computation*

Sums "made good" are not deductible as such in the section 106 computation. Rent is deductible in a section 106 computation but the interest foregone on an interest-free loan is not rent. No-one suggests that the company would be taxable under Schedule A!

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 section 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*

22 It is assumed that the interest foregone exceeds the annual or rateable value of the accommodation, which will normally be the case.

23 See the discussion on "sum" in 8.28 (Chattels brought to the UK).

their Shareholders, Key Haven Publications, paragraphs 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*.

42.20.3 *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.[24] However, the interest foregone on the loan is not "reimbursement". In addition, it is also not a "payment".

42.20.4 *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

24 See 42.19 (Reimbursement as solution to IT charge).

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 section 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.

42.20.5 *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.[25] In practice HMRC accept this.

42.21 Co-ownership defence to living accommodation charge

Suppose an individual owns a share in the property jointly with the company. It is argued that he occupies the property as co-owner and the company does not "provide" accommodation.

Co-ownership raises similar but not identical issues for other provisions which charge tax on benefits, such as s.87 TCGA, s.731 ITA, s.203

25 See 42.13.3 (Making good: timing)

ITEPA, and IHT gift with reservation rules. 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.

42.21.1 *The land law position*[26]

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".[27] The position is governed by the Trusts of Land and Appointment of Trustees Act 1996.[28] 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 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. See *IRC v Lloyds Private Banking*:

> 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

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26 I am grateful to Charles Harpum for his assistance on this section.

27 (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 for tax purposes. (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.

28 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.

rent ...[29]

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…[30]

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.[31]

In the following discussion, the entitlement to occupy land conferred by section 12(1) is called the “statutory occupation right”.

The individual will obviously have a statutory occupation right to occupy the property under section 12 because:

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29 [1998] STC 559 at p.561; likewise *City of London Building Society v Flegg* [1988] AC 54 at 81.

30 [2002] STC 1109 at [24] reported 75 TC 340 under the name *IRC v Greenstock's Executors*.

31 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 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.

(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:[32]

(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).[33]

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 section 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.

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:

32 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.

33 Also section 12(2) TLATA would probably apply, though it is not necessary to rely on that.

> Where the entitlement of any beneficiary to occupy land under section 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 section 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 section 13(3) except to require the individual to pay outgoings.[34]

It is reasonably clear that sections 12–14 TLATA are a comprehensive code and there is no common law right to an occupation rent except in a

34 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.

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.[35] 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 section 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.[36]

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 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.

35 Sections 6, 14 TLATA.

36 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.

In *IRC v Eversden*[37] 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.[38]

Unfortunately this conclusion, which was with respect plainly right, 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 ...[39]

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 in those shares from the outset.

It is unfortunate that *Eversden* was not cited in *Vasili* since the two cases

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37 [2002] STC 1109 reported 75 TC 340 under the name *IRC v Greenstock's Executors*.

38 76 TC 116 at p.124, para.22.

39 76 TC 116 at p.131, para.13.

are difficult to reconcile.

42.21.2 *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.[40]

If the company incurs costs of maintenance, that is an employment related benefit.

42.21.3 *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? [41]

In *IRC v Eversden (Greenstock's Executors)* trustees purchased a 95% share in a house ("Meadows"), and the settlor purchased 5%. The judge said:

> 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*

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40 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.

41 This issue does not arise where the company receives its share of the land gratuitously.

occupy Meadows for an indefinite period rent free.[42]

(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.

42.21.4 *The HMRC view*

The EI Manual provides at 11414:

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42 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.

> **Living accommodation: Avoidance area: Co-ownership cases**
> [December 2005]
> 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.

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.[43]

But this view is very difficult to defend.

42.22 Some other defences

42.22.1 *The caretaker's defence*

Section 99 ITEPA provides:

43 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 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. ...

42.22.2 *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.[44]

42.22.3 *Lease premium scheme*

HMRC Manual provides:

> **11415. Living accommodation: Avoidance area: Lease premium cases** [December 2005]
> In these cases the employer takes a short lease on living accommodation from a third party. Instead of just paying the market rent for the property the employer pays a large premium and a small annual rent. It is argued that none of the premium can be treated as rent for the purpose of measuring the cash equivalent of this benefit.
> An example will illustrate the point. A London flat owned by a third party has a market rental value of £25,000 per annum and gross rateable value under the old rating system of £800. An employer enters into a 3 year lease with the third party paying a premium of £75,000 and a rent of £100 per annum. The employer then provides the flat rent free to an employee. The cash equivalent of the benefit is the higher of:
> - the gross rateable value and
> - the actual rent payable.
>
> It is argued that the cash equivalent of the living accommodation benefit is £800 gross rateable value because none of the £75,000 can be treated as rent.
> In some circumstances we might wish to argue that the premium should be treated as rent. Please submit your papers to Personal Tax, (Technical), Solihull in any case on which you wish to argue the point.

In *Toronto-Dominion Bank v Oberoi* [2004] STC 1197, the employee intended to take advantage of this idea. Unfortunately the spectacularly misdrafted lease referred to "rent" and not to a premium![45] Fortunately the Judge ordered rectification of the lease. The case contains an interesting discussion on the distinction between rent and premium; in the light of this the argument put forward in the Manual (that the premium is in fact

44 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.

45 The obvious lesson is that tax sensitive documentation drafted by property lawyers must be reviewed by tax lawyers. But it seems that every generation must learn this the hard way. For another example see *Hurlingham Estates v Wilde* [1997] STC 627.

rent) will be hard to maintain if the documentation is carefully drawn.

42.23 Home outside UK

Some practitioners argued that the pre-ITEPA legislation did not apply to property outside the UK. The argument does not arise (or at least has been weakened) under ITEPA. Now a new relief is proposed. BN50 (21 March 2007) provides:

> 2. The Government has today announced its intention to bring forward legislation in Finance Bill 2008 which will ensure that individuals who have bought or will buy a home abroad, will not face a benefit in kind tax charge for any private use of the property if purchased through a company.
> 3. Some UK resident individuals have set up or acquired companies to own a property abroad, generally for holiday use. Where they direct the company's affairs (whether through an agent or not) they can be within the scope of the living accommodation charge, although they may not have been aware of this or may have considered that no tax or NICs charge arose in these circumstances (and have not, therefore, reported the matter to HMRC). ...
> 8. Draft legislation will be published for consultation later this year. HMRC will not seek to tax anyone in the intervening period where the following conditions are met:
> - The property is owned by a company owned by individuals;
> - The company's only activities are ones that are incidental to its ownership of the property;
> - The property is the company's only or main asset; and
> - The property is not funded directly or indirectly by a connected company.

The back-dating of reliefs by legislation to be enacted at leisure is unusual in UK tax administration. It seems churlish to complain at delay for consultation. But what is needed is a more thorough review of this unsatisfactory area of law. Almost every proposed restriction 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.

The legislation was published in draft on 17 July 2007. A new s.100A and 100B ITEPA is proposed. Draft s.100A ITEPA provides:

> **100A Homes outside UK owned through company**
> (1) This Chapter does not apply to living accommodation outside the UK provided by a body corporate ("the company") for a director of the company ("D") or a member of D's family or household if—
> (a) D, or D and other individuals, own the company's issued share capital (and none of that share capital is partnership property), and
> (b) the company has been the holding company of the property at all times after the relevant time.[46]

Thus the relief does not apply if any shares are held by a trust or by a company.

The relief only applies to directors (not employees unless also directors) but in practice that does not matter.

> (2) The company is "the holding company of the property" when—
> (a) it owns a relevant interest[47] 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.

Draft s.100B ITEPA sets out wide exceptions:

> **100B Section 100A(1): exceptions**
> (1) Section 100A(1) does not apply if subsection (2), (3) or (4) applies.

46 Defined in draft s.100A(3) ITEPA:

"'the relevant time' means the time the company first owned a relevant interest in the property."

47 Defined in draft s.100A(3) ITEPA:

"'relevant interest in the property' means an interest (under the law of any territory) that confers a right to exclusive possession of the property at all times".

The first two exceptions concern connected[48] companies:

> (2) This subsection applies if—
> (a) the company's interest in the property was acquired[49] (directly or indirectly) from a connected company at an undervalue, or
> (b) the company's interest in the property derives from an interest[50] that was so acquired.
> (3) This subsection applies if, at any time after the relevant time (as defined by section 100A(3)—
> (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.

Lastly there is an all-purpose tax motive restriction:

> (4) This subsection applies if the living accommodation is provided in pursuance of an arrangement[51] the main purpose, or one of the main purposes, of which is the avoidance of tax or national insurance contributions.

The new provisions are to be backdated. The draft clause provides:

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48 "Connected" is very widely defined in draft s.100A(8) 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."

49 Draft s.100B(5) ITEPA provides a commonsense definition:

> "In subsection (2), references to the acquisition of an interest include the grant of an interest."

50 Draft s.100B(6) ITEPA provides a commonsense definition:

> "For the purposes of subsection (2)(a), 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)."

51 Draft s.100B(7) ITEPA provides a pointless 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."

(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 United Kingdom provided in circumstances in which, had it been provided on or after 6 April 2003, section 100A(1) of ITEPA 2003 would cause Chapter 5 of Part 3 of ITEPA 2003 (taxable benefits: living accommodation) not to apply.

42.24 Benefit in kind remittance basis

This section deals with the position of a UK resident and ordinarily resident but foreign domiciled individual 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".

42.24.1 *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.[52] Thus one has to ascertain:

(1) what are the duties;

(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.[53] I think a Court is not likely to accept this. If a shadow director is deemed to have

52 See 10.3 (Chargeable overseas earnings).

53 (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.

an employment, it follows that he can 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).

42.24.2 *Are BIK earnings remitted to the UK?*

If BIK earnings are "chargeable overseas earnings", they are taxable only if remitted to the UK. The meaning of "remitted to the UK" is discussed in 10.13 (Meaning of "remitted to the UK"). They are treated as remitted if they are:

(a) paid, used, or enjoyed in the UK, or
(b) transmitted or brought to the UK in any manner or form.

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 earnings which do not exist cannot be remitted. The tax charge arises only if the earnings are remitted. The property (or the benefit of its use) is not the same as the earnings. HMRC do 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 Section 22 or Section 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 Section 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 Section 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)

42.25 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.[54] Thus one must ascertain:

(1) what are the duties;

(2) whether the earnings are in respect of the duties;

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54 See 10.8 (Non-resident employee).

(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 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 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.[55]

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.

42.26 Other planning possibilities using companies

More complex possibilities involve:

(1) acquiring a property,

(2) granting (say) a ten year lease to trustees, 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

55 See *R v Dimsey & Allen* [2002] 1 AC 509 at [19].

be carried out with options. In practice, arrangements of this complexity would not often be needed.

42.27 Dealing with company structures 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?

42.27.1 *Planning involving winding up of the company structure*

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 would be:

(1) to procure that the trust has an interest in possession for the occupier; and

(2) to liquidate the company.

The liquidation may give rise to a capital gain but this should not be a problem for a non-UK domiciled beneficiary. 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 42.1 (Ownership 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 paragraph 37.10 (Deduction for debts of trustees). Watch SDLT.

Another possibility may be to reimburse the company for the cost of providing the accommodation. Watch the CGT implications.

42.27.2 *Planning not involving winding up the structure*

If the individual is UK domiciled then CGT may make it impractical to wind up the structure. In that case take stringent steps to ensure that the individual is not a shadow director.

42.28 Dealing with living accommodation enquiries in practice

In practice, as *Al Fayed v Advocate General* frankly reports,[56] 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 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 Special Commissioners or beyond.

42.29 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.

56 [2002] STC 910 para. 44.

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.

42.30 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; see 17.4.4 (Enjoyment of assets in kind). 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.

42.31 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".[57] Where a non-resident company controlled 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:

57 Accepting the argument of Robert Venables QC in 8 OTR 165.

> 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 accommodation in an enterprise, but that is not "just personal use".

42.32 SDLT on living accommodation charge

FA 2003 Sch. 4 para.12 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 section 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 section 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 very 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 definition[58] does not apply here.

42.33 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 IT problems similar but not identical to the living accommodation charge.

42.33.1 *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".

42.33.2 *Employment-related benefit*

This is defined in s.201(2) ITEPA:

> In this Chapter—
> "benefit" means a benefit[59] 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.[60] EI Manual 21002 provides:

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58 See 42.8.1 ("By reason of the employment").

59 For the meaning of "benefit" see 17.4 (Benefit).

60 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.

> 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,[61] which is provided in a tax year—
> (a) for an employee, or
> (b) for a member of an employee's family or household,
> by reason of the employment.[62]

42.33.3 *"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[63] 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:

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61 "Excluded benefit" is defined in s.202.
62 For the definitions of expressions used here see 42.8 (Defined terms).
63 "Made good" is discussed at 42.13.2 (Making good).

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 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;[64]

(b) in any other case, 20% of the market value[65] 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). ...[66]

(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

64 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.

65 Market value is defined in a commonsense way in s.208 ITEPA.

66 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.

the asset.[67]

42.33.4 *Asset available but not used*

EI Manual provides at 21631:

> Note that a tax charge arises 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

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67 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.

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.[68]

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 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 (Section 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

68 [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.

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 Section 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 (Section 205(1)(a)(i) ITEPA 2003) and
- making an apportionment of that benefit where it is available to a director and for "other matters" (Section 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 (Section 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 Section 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 Section 365(1) ITEPA 2003 for any business use that meets the conditions of Section 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 Section

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 (Section 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" (Section 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 Section 336 ITEPA 2003 he will be due a deduction under Section 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 Section 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 Section 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.

42.33.5 *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 section 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.

42.34 "Person providing benefit"

This is defined in s.209:

> **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 FORTY THREE

PRE-OWNED ASSETS

43.1 Terminology

This chapter considers the provisions in Schedule 15 FA 2004 ("POA provisions"). References in this chapter to "paragraphs" are to paragraphs of that Schedule. The supplementary regulations (whose title is so long it cannot sensibly be used)[1] are referred to as "the POA Regulations". HMRC issued 25 pages of "Technical Guidance" in 2004 but this document was not very technical and did not contain much guidance. The professional bodies then raised 44 questions, some of which were answered by HMRC under COP 10. I refer to this as "the CIOT Statement" as it was published on the CIOT website on 13 October 2005. A revised version was published on 13 March 2006.[2] Further material is now in the POA Guidance section of the HMRC website[3] ("Website POA Guidance").

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 shall call:

(1) The POA land charge.

(2) The POA chattel charge.

(3) The POA intangible property charge.

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1 The Charge to Income Tax by Reference to Enjoyment of Property Previously Owned Regulations 2005.

2 Accessible *www.tax.org.uk/showarticle.pl?id=3839;n=232*.

3 *www.hmrc.gov.uk/poa/index.htm*.

Land, chattel and intangible property are given commonsense definitions.[4]

43.2 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.

43.3 POA land charge

Paragraph 3(1) 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. Technical Guidance makes some general observations on the meaning of occupation at 4.6.

43.4 The disposal conditions

Paragraph 3(2) 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

4 Paragraph 1.

5 *www.publications.parliament.uk/pa/jt200304/jtselect/jtrights/93/9305.htm.*

acquisition of an interest in the relevant land, and
(b) the chargeable person has disposed[6] of all, or part of, his interest in 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.

43.4.1 *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 case the exclusion for arm's length transactions may apply.

43.4.2 *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

6 "Disposal" is defined in paragraph 3(4).

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.

43.5 The contribution conditions

Paragraph 3(3) 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.

43.5.1 *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.

43.5.2 *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.

43.6 "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]

If T provides funds to A, who gives them to B, who purchases the property: it is suggested that T has not provided the consideration if the "clean break" test is satisfied; see 45.4.1 (When is A an indirect settlor?).

It is suggested 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? Probably T has provided the consideration if the two steps form a single arrangement. But it might be argued that A provides the consideration himself (by his promise to repay T) and all that T has provided is the interest foregone.

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

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.

fund X to a company or trust, which borrows fund Y from a third party, and the company or trust uses both funds to acquire the property, then T has provided fund X but not fund Y.

What if T subscribes for shares on arm's length terms? Probably T has "provided" funds to the company.

Traditional IHT planning (where an offshore company is used to hold a foreign domiciliary's residence) will satisfy the contribution condition. It will apply where, under a single arrangement:

(1) a foreign domiciliary lends funds interest-free to a company which acquires the home; or

(2) a foreign domiciliary gifts funds to a trust which lends interest-free to the company which acquires the home.[8]

43.6.1 *Provisions of funds for purpose of acquisition*

It is probably not necessary that T provides funds 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*.[9] 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 arguable that T has not provided the consideration

8 It would also apply if the trust purchases the home (without a company) but in this situation the estate or GWR exemption is likely to apply; see 43.15 and 43.21.

9 [1943] AC 468. This is consistent with paragraph 10(2)(c) which envisages a seven year gap between the provisions of funds and the occupation of the land. But the contrary view is arguable.

unless the two steps form a single arrangement.

43.6.2 *Guarantees*

Paragraph 17 provides:

> **Guarantees**
> 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.

43.6.3 *Secondhand company*

The contribution condition will not be satisfied where:

(1) One individual has provided funds to a company to purchase a house.

(2) He sold the company to a second individual who occupies the house.

The second individual has not provided the funds for the purchase (unless the two steps form a single arrangement): see 15.9.1 (Purchase of funded company).

43.6.4 *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.

43.7 POA chattel charge

Paragraph 6 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[10] 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

10 "Disposal" is further defined in paragraph 6(4).

This follows the form of the POA land charge.

43.8 POA intangible property charge

Paragraph 8 provides:

> (1) This paragraph applies where—
> (a) the terms of a settlement,[11] 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-paragraph (2) is met ("the relevant property").
>
> (2) The condition mentioned in sub-paragraph (1)(c) is that the property is intangible property which is or represents property which the chargeable person settled, or added to the settlement, after 17 March 1986.

In practice the GWR or estate exemptions will usually be available here, so the POA intangible property charge will not usually affect foreign domiciliaries. An important question is whether paragraph 12(3) disapplies these exemptions in the case of a former foreign domiciliary. See 43.25 (Former foreign domiciliary).

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 for those schemes its effect may be avoidable.

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11 "Settlement" here has the IHT meaning, not the income tax meaning: paragraph 1.

43.9 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. Paragraph 10(1) defines "excluded transaction" for the disposal conditions and paragraph 10(2) defines the phrase for the contribution conditions. Each sub-paragraph contains five categories of excluded 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.

43.10 Excluded transactions: disposal conditions

43.10.1 *Arm's length exclusions*

Paragraph 10(1) 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 POA Regulations:

> Paragraph 3 (land) and paragraph 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[12], or

(ii) the disposal was made before 7 March 2005.

One might think the word "not" is included accidentally in 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 Technical Guidance states (Appendix 1):

> If Miss B acquires 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. The onus will be on the taxpayer to show that Miss B's claim to a share of the property would meet with the approval of the Court.

12 Defined in regulation 5(2).

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 it seems that HMRC do not really care about it. The Technical Guidance continues:

> C, an existing partner, brings his son D into the partnership. In return for D's agreement to take on most of the day-to-day running of the partnership C gives him a share in the partnership. In the circumstances of this case, it is accepted that D's agreement constitutes consideration in other than money or realisable assets and that the transaction is one that might be expected to be made at arm's length. The Regulations provide that such a disposal is exempt from the income tax charge for the purposes of this Schedule.

This really is worrying, if HMRC take the point seriously, but foreign domiciliaries as such are not likely to be affected.

43.10.2 *Spouse exclusions*

The second and third categories of excluded transaction are in paragraph 10(1)(b) and (c):

> (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.[13]

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 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

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13 This is restricted by paragraph 10(3):
"A disposal is not an excluded transaction by virtue of sub-paragraph (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."

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).

43.10.3 *Disposition for maintenance of family*

The fourth category of excluded transaction is in para 10(1)(d):

> the disposal was a disposition falling within section 11 of IHTA (dispositions for maintenance of family).

43.10.4 *Annual exemption and small gifts*

The fifth category of excluded transaction is in para 10(1)(e):

> the disposal is an outright gift[14] 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.

43.11 Excluded transactions: contribution conditions

43.11.1 *Four exclusions*

Para 10(2) 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 spouse or civil partner or former spouse or civil partner is beneficially entitled to an interest in possession.

These are the equivalent of 43.10.2 (Spouse exclusions). The spouse trust

14 See 43.12 (Meaning of "outright gift").

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) 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 43.10.3 and 43.10.4 (family maintenance, annual exemption and small gifts).

43.11.2 *Outright gift of money*

The remaining exclusion is in para.10(2)(c) where:

> (c) the provision of the consideration constituted an outright gift[15] 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 paragraph 3(1)(a)[16] or, as the case may be, 6(1)(a).[17]

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.

43.12 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

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15 See 43.12 (Meaning of "outright gift").
16 i.e. occupies the relevant land.
17 i.e. has possession of the chattels.

contribution conditions.[18]

(2) Outright gifts of money (whether or not to an individual) are excluded for the disposal condition.[19]

"Outright gift" is not defined.[20] 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.

43.13 Exemptions from charge

Paragraph 11 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) exemptions (charities and other specialist areas) not discussed here.
(4) Para 11(5)(c) exemption (jointly occupied property) not discussed here.
(5) Full consideration exemption.

43.14 "Relevant property"

A key concept in paragraph 11 is "relevant property" defined in para 11(9). 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

---

18 See 43.10.4 (Annual exemption and small gifts); 43.11.1 (Four exclusions).

19 See 43.11.2 (Outright gift of money).

20 The term "outright gift" is partially defined in s.626 ITTOIA; see 41.17 (IT planning for mixed marriage), but that definition does not apply here.

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,[21] 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 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? 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 in each case the relevant property is the house, but the benefit of the loan, or the shares, may be derived property: see below.

In relation to the POA intangible property charge, "relevant property" has the meaning given in paragraph 8 (roughly, the settled property).

43.15 Estate exemptions

43.15.1 *Full estate exemption*

Paragraph 11(1) provides that the POA charges:

> 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 exemption referred to below).

For the purposes of discussion I shall assume the "relevant property" is a house. If T transfers his house to a trust under which he has a recognised interest in possession, the estate exemption will apply. However, transfers on or after 22 March 2006 will not normally give rise to a recognised IP, so the exemption is mainly of importance to pre-2006

21 See 43.6 ("Provide").

trusts.

43.15.2 *Partial estate exemption*

Paragraph 11(2) provides:

> Where the estate for the purposes of IHTA of a person to whom paragraph 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 paragraph 4, the appropriate amount in paragraph 7 or the chargeable amount in paragraph 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".

43.16 Derived property

In the following discussion:

(1) "Fully derived property" is property falling within paragraph 11(1)(b).[22] 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 paragraph 11(2). That is property:

22 In para. 11 this is simply called "derived 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) "substantially[23] less" than the value of the house?

43.16.1 *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.

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;

---

23 "Substantially" is, obviously, not a precise word. The Technical 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."

(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 11(1)(b)(i). Otherwise the condition in 11(1)(b)(ii) 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).

43.16.2 *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.

It cannot be said that the loan derives its value not from the underlying property (the house) but from the contractual undertaking that obliges the company to repay. 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**
>
> B owns 100 £1 shares in X Limited and otherwise funds it by shareholder loan. (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. It would appear that para 11(1) protects him. The shares are not 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. We cannot comment on whether this result is odd.

This is plainly wrong and I would be surprised if HMRC tried to defend it if seriously challenged.

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 derive their value from the house).

What if T lends to a trust which purchases a house? If the loan is on a non-recourse basis[24] the loan is fully derived property. It is suggested that the same applies even if the trustees are personally liable for the loan.

43.17 Excluded liability rule

Paragraph 11(6) 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-paragraph (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 35.17 (GWR property subject to debt).

43.17.1 *"Excluded liability"*

The term "excluded liability" is defined in paragraph 11(7):

> For the purposes of sub-paragraph (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.

24 i.e. the trustees' liability to repay is restricted to the trust assets or their value.

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 paragraph 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) 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). But we know that the purpose of para.11(7) is to *catch* double trust plans. The effect of this construction would be to *defeat* the intention of the legislation. The argument would mean asking the Courts to frustrate the actual intention of the legislation. So the argument is unlikely to succeed.

43.18 "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.

43.19 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.[25]

43.19.1 *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 37.7.1 (Debt owed by non-settlor life tenant to trust).

43.19.2 *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.)

43.19.3 *Bank borrowing*

What if T (or trustees of a trust in which T has a recognised IP) 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 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.[26]

43.19.4 *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.

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25 See 37.2 (Deduction for liability of individual).

26 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.

43.19.5 *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.[27] 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.

43.19.6 *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.

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27 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.

> 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 paragraph 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 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 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).

43.20 Reverter to settlor restriction

The FA 2006 introduced a restriction to the estate and GWR exemptions:

> (11) Sub-paragraph (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[28]

28 Paragraph 11(13) defines "derived property" in terms which repeat the wording of paragraph 11(1)(b) verbatim.

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-paragraphs (1) and (2) as comprised in his estate at that subsequent time, and
(b) are not to be treated as falling within sub-paragraph (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) 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 (paragraph 11(1) Schedule 15 – for example, because it has been given back to them), or when it is treated as back in their estate (paragraph 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.
> 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;[29]

29 Author's note: This is not of course generally possible after 22 March 2006.

- for IHT purposes, B is therefore treated as owning the house by virtue of section 49 IHTA and so paragraph 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 paragraph 11(11) and the EN. The reverter to settlor restriction applies wherever a person has a recognised IP 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 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 paragraph 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 paragraph 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 paragraph 11(11)(a) redundant, since that relates to cases where the disposal condition is met and paragraph 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 (*paragraph 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 (*paragraph 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 (*paragraph 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.

43.21 GWR exemptions

43.21.1 *Full GWR exemption*

Paragraph 11(3) and (5) provide:

(3) Paragraphs 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-paragraph (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 paragraphs (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 paragraph 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 35.3 (Terminology).[30]

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).[31]

(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 43.25 (Former foreign domiciliary).

43.21.2 *Partial GWR exemption*

Paragraph 11(4) provides:

> Where any property which falls within sub-paragraph (5) in relation to

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30 For this purpose para 11(8) tinkers with the GWR tracing rules:

> "In determining whether any property falls within sub-paragraph (5)(b), (c) or (d) in a case where the contribution condition in paragraph 3(3) or 6(3) is met, paragraph 2(2)(b) of Schedule 20 [FA 1986] (exclusion of gifts of money) is to be disregarded."

The Technical Guidance gives an example at 4.2.

31 The position is the same for an unrecognised IP trust if T is the object of a wide power of appointment (so there is a GWR).

> 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 paragraph 4, the appropriate amount in paragraph 7 or the chargeable amount in paragraph 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).

43.22 Full consideration exemption

The full consideration exemption in paragraph 11(5)(d) 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 paragraph 6 FA 1986.

There are two exemptions here:[32]

(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) Schedule 20 FA 1986 provides two exemptions to the GWR rule. The first is:

> 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

32 Another possible reading is that the exemption only applies if s.102C(3) and Schedule 20 para 6 both apply, i.e. it is not enough that Schedule 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 are alternatives. They cannot both apply. *Hansard* confirms this (if it were necessary): HC 7 July 2004 col.881, 900. The Technical Guidance agrees.

> 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) Schedule 20 is less likely to be important in practice.

43.23 Non-resident taxpayer

Paragraph 12(1) 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.

43.24 UK resident foreign domiciliary

Paragraph 12(2) provides:

> Where in any year of assessment a person is resident in the UK but is domiciled[33] outside the UK, this Schedule does not apply to him unless the property falling within paragraph 3(1)(a), 6(1)(a) or 8(1)(c) is situated in the UK.

33 "Domiciled" is defined in paragraph 12(4):

> " 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."

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.

Paragraph 12 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.

43.25 Former foreign domiciliary

Paragraph 12(3) provides:

> In the application of this Schedule to a person who was at any time domiciled[34] 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[35] by virtue of section 48(3)(a) of that Act.

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) is to be contrasted with *is* in para. 12(2).)

Suppose:

(1) T (not UK domiciled) creates a discretionary trust of which he is a beneficiary;

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34 See above footnote.

35 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.

(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 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.[36] This was certainly not foreseen at the time the legislation was passed. It is suggested that paragraph 12(3) 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:

> Paragraph 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

36 A further tax charge would arise if (as some have argued) T is also caught by the GWR rules on his death; see 35.13 (GWR and excluded property rules).

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 paragraph 7.1 about the interaction between paragraphs 12(3) and 11.

43.26 Quantum of charge: land

We find the usual cascade of definitions. Paragraph 3(5) 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 paragraph 4 is to be treated as income of his chargeable to income tax.

43.26.1 *The chargeable amount and deductible expenses*

One therefore turns to paragraph 4 to find the quantum of the charge. Para. 4(1) provides:

> For any taxable period[37] 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

37 "Taxable period" is defined in a commonsense way in paragraph 4(6):

> "In this paragraph—
> 'the taxable period' means the year of assessment, or part of a year of assessment, during which paragraph 3 applies to the chargeable person."

(2) payment to the owner of the relevant land.

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)?

43.26.2 *"The appropriate rental value"*

This is defined in paragraph 4(2). 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.

43.26.3 *"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 paragraph 5. 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.[38] 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.

43.26.4 *The proportion (DV ÷ V)*

The key expression is DV:

> DV is—
> (a) in a case falling within paragraph 3(2)(a)(i),[39]
> [i] the value as at the valuation date of the interest in the relevant land that was disposed of as mentioned in paragraph 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 paragraph 3(2)(a)(ii),[40]
> [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 paragraph 3(3),[41] 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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38 See 42.13.1 (Rental value of the accommodation).

39 i.e. disposal condition (i); see 43.4.1(Disposal condition (i)).

40 i.e. disposal condition (ii), see 43.4.2 (Disposal condition (ii)).

41 i.e. the contribution condition; see 43.5 (The contribution condition).

43.26.5 *(DV÷V) and the valuation date*

The valuation date is determined by the 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.

43.26.6 *Non-exempt sale*

Paragraph 4(4) provides a relief for a "non-exempt" sale. Para 4(4) 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) 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.

43.27 Quantum of charge: chattels

Paragraph 6(5) 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 paragraph 7 is to be treated as income of his chargeable to income tax.

43.27.1 *The chargeable amount*

Paragraph 7(1) provides:

> For any taxable period the chargeable amount in relation to any chattel is
> [a] the appropriate amount (as determined under sub-paragraph (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.

43.27.2 *The appropriate amount*

Paragraph 7(2) 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[42] if interest were payable at the prescribed rate on an amount equal to the value of the chattel [at][43] the valuation date,

DV is—

(a) in a case falling within paragraph 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 paragraph 6(2)(b) by the chargeable person or,
  [ii] where the disposal was a non-exempt sale,[44] the appropriate proportion of that value,
(b) in a case falling within paragraph 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 paragraph 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.

43.28 Quantum of charge: intangible property

Paragraph 8(3) 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 paragraph 9 is to be treated as income of the chargeable person chargeable to income tax.

43.28.1 *The chargeable amount*

Paragraph 9(1) provides:

> For any taxable period the chargeable amount in relation to the relevant

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42 Paragraph 7(5) provides that "the taxable period" means the year of assessment, or part of a year of assessment, during which paragraph 6 applies to the chargeable person.

43 The statute erroneously reads "as".

44 Non-exempt sale is defined in para. 7(3) following the form of the POA land charge: see 43.26.6 (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[45] 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 foreign domicile defence, it is considered that the amount of T is nil.

43.28.2 *The valuation date*

Paragraph 9 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.

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45 Paragraph 9(3) provides:

"'the taxable period' means the year of assessment, or part of a year of assessment, during which paragraph 8 applies to the chargeable person".

The date is prescribed in the POA Regulations.

43.29 Overlap of land and intangible property charges

Paragraph 18 provides:

> *Persons chargeable under different provisions by reference to same property*
> 18—
> (1) Where, in any year of assessment, a person ("the chargeable person") is (apart from this paragraph) chargeable to income tax both—
> (a) under paragraph 3 (land) or paragraph 6 (chattels) by reason of his occupation of any land or his possession or use of any chattel, and
> (b) under paragraph 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-paragraph (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 paragraph 13(2).

43.30 Interaction with benefit in kind charge

Paragraph 19 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.

43.31 *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. Paragraph 13 provides:

> (1) This paragraph applies where, in relation to any person who would (apart from this paragraph) be chargeable under this Schedule for any year of assessment, the aggregate of the amounts specified in sub-paragraph (2) in respect of that year does not exceed £5,000.
> (2) Those amounts are—
> (a) in relation to any land to which paragraph 3 applies in respect of him, the appropriate rental value as determined under paragraph 4(2),
> (b) in relation to any chattel to which paragraph 6 applies in respect of him, the appropriate amount as determined under paragraph 7(2), and
> (c) in relation to any intangible property to which paragraph 8 applies in respect of him, the chargeable amount determined under paragraph 9.
> (3) Where this paragraph applies, the person is not chargeable for that year of assessment under any of the following provisions—
> (a) paragraph 3(5) (land),
> (b) paragraph 6(5) (chattels), or
> (c) paragraph 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 paragraph 4(2):

> 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 paragraph 4(6):

> "the taxable period" means the year of assessment, or part of a year of assessment, during which paragraph 3 applies to the chargeable person.

Thus it seems clear that if para. 3 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) disapplies para. 3: see para. 11(1).

43.32 Election out of POA regime

One can elect out of the POA charges at an IHT cost. Paragraph 21 deals with the POA land and chattels charges. Paragraph 22 deals with intangible property. They are not quite the same but for reasons of space I shall only cover the former.

43.32.1 *Conditions for election*

Paragraph 21(1) provides

> This paragraph applies where—
> (a) a person ("the chargeable person") would (apart from this paragraph) be chargeable under paragraph 3 (land) or paragraph 6 (chattels) for any year of assessment ("the initial year") by reference to his enjoyment[46] 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.

43.32.2 *Effect of election*

Paragraph 21(2) provides:

46 "Enjoyment" is defined in paragraph 21(4):
"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."

> The chargeable person may elect in accordance with paragraph 23 that—
> (a) the preceding provisions of this Schedule shall not apply to him 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-paragraph (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 35.13 (GWR and excluded property).

43.32.3 *The chargeable proportion*

This takes us to the definition of "chargeable proportion" in para. 21(3):

> 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 paragraph 4(2) or 7(2), as the case requires, but as if—
> (a) any reference in paragraph 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 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 paragraph 21(3)(b).
How does this work in the case of an *Ingram* scheme?

43.32.4 *Time limit for election*

Paragraph 23(3) 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 paragraph 23(1):

> "the relevant filing date" means 31 January in the year of assessment that immediately follows the initial year within the meaning of paragraph 21 or (as the case requires) paragraph 22.

Time runs from when the Schedule begins to apply. Normally that will be 6 April 2005,[47] because in the future no-one will deliberately enter into arrangements caught by the Schedule. But where a person is non-resident

47 Or 6 April 2007 for those caught by the reverter to settlor restriction in the FA 2006; see 43.20 (Reverter to settlor restriction).

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 election starts at that later time; a sensible rule. The Technical Guidance discusses when a late election is accepted at 3.4.

43.32.5 *Revocation of election*

Paragraph 23(5) 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.

43.32.6 *Retrospective effect of election*

Paragraph 23(6) provides:

> Subject to sub-paragraph (5), the election takes effect for the purposes of inheritance tax from the beginning of the initial year within the meaning of paragraph 21 or (as the case requires) paragraph 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.

43.33 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.

43.34 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.

43.34.1 *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.

43.34.2 *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.

43.35 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 43.26.1 (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.[48] Consider it if IHT is a long term problem (middle-aged clients). Perhaps a future Conservative government will scrap these rules in a

48 See 41.7 (Spouse exemption defence to GWR charge on death).

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 follow the election); and

(3) A sale of the company is envisaged in the short or medium term. See paragraph 43.6.3 (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.

43.36 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.

43.37 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.) But 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[49] then it is anomalous to charge income tax on the benefit of

49 See Kay and King, *The British Tax System*, 5th ed., 1990, p.80.

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 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.[50] 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.[51] 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 new 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*[52] schemes;

(2) *Ingram*[53] and similar shearing schemes;

(3) "double trust" schemes.

This is unprecedented in the UK tax system, which has traditionally allowed taxpayers to plan their affairs more securely on the basis of the

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50 And to stop similar arrangements being made in the future.

51 *Re a By-law of the Auckland City Council* [1924] NZLR 907 at 911.

52 *IRC v Eversden (Greenstock's Executors)* 75 TC 340.

53 *Ingram v IRC* [1999] STC 37.

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. What should not be controversial is that those who have done *Ingram* schemes have been 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 do not seriously try.[54]

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54 "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 FORTY FOUR

ESTATES OF DECEASED PERSONS[1]

44.1 Introduction

On the death of a person domiciled in England and Wales,[2] 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".

Special taxation rules apply during this period of administration. The interplay of the rules produces some curious results where a foreign domiciliary is a beneficiary or testator. There can sometimes be considerable scope for tax planning. I shall discuss the position where a foreign domiciliary is:

(1) a testator,

(2) a pecuniary legatee (entitled to a cash legacy),

(3) a specific legatee (entitled to specific assets), and

(4) a residuary legatee.

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1 Many of the issues discussed here arise in a similar way where charities are beneficiaries of estates, as to which see *Taxation of Charities* (James Kessler QC, Key Haven, 5th ed., 2005) (Chapter 29 Estates of deceased persons).

2 Further consideration is needed on the death of a person domiciled outside England and Wales.

I first consider CGT and then income tax.

44.2 Residence and domicile of PRs for CGT

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.
>
> (Paragraphing added)

The residence and domicile of the PRs in their private capacity is irrelevant.

44.3 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 trust gain. (By contrast, assets with losses should be transferred *in specie*.) It is also desirable to extend the administration period as long as possible.

44.3.1 *Is an estate a "settlement" within s.87 TCGA?*

Could gains accruing to the PRs be "trust gains" within the scope of s.87 TCGA?[3] 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 ...

3 See 30.6 (The s.87 charge).

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 20[4] at all; it is not a settlement to which the Act applies.

Lord Goddard did not clearly say that a will is not a "settlement" but if that is what he means, the comment was *obiter* and clearly wrong. A deceased's estate is a "settlement" in the sense of "arrangement" and a trust under a will is a settlement in the strict sense of the word. 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.[5] Accordingly CG Manual (June 2005) 14591 is right to provide:

> A will trust cannot be a Settlement for these [IT] purposes.

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 beneficiaries is not (without a considerable stretch) a capital payment.
Section 87(9) 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 his death.

This shows that a settlement arising under a will or intestacy is a "settlement" for s.87 purposes.[6] But this only applies once the administration of the estate is completed.

44.4 Gains accruing to non-resident company held by PRs

Suppose:

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4 Section 20 FA 1943, the predecessor of s.644 ITTOIA.

5 *Willingdale v Islington Green Investment Co* 48 TC 547 at 556. (The point was not argued on appeal.)

6 Section 97(7) TCGA also shows that, before it was amended by the FA 2006.

(1) PRs hold a non-resident company.

(2) The company disposes of an asset and realises a gain, which I call “the company gain”.

44.4.1 *Position of company and PRs*

The company is not subject to tax on the company gain because it is not UK resident. Section 13 TCGA provides:

> (1) This section applies as respects chargeable gains accruing to a company—
> (a) which is not resident in the United Kingdom, and
> (b) which would be a close company if it were resident in the United Kingdom.
> (2) Subject to this section, every person who at the time when the chargeable gain accrues to the company
> [a] is resident or ordinarily resident in the United Kingdom,
> [b] who, if an individual, is domiciled in the United Kingdom, and
> [c] 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 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] is not satisfied.

44.4.2 *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 and domiciled; or

(2) if the legatee is a non-resident trust it would be treated as receiving a

"trust gain" under s.13(10) TCGA?[7]

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).

This takes us to s.417(1) ICTA:

> For the purposes of this Part, a "participator" is, in relation to any company, a person having a share or interest in the capital or income of the company, 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, a right to receive or participate in distributions of the company (construing "distributions" without regard to section 418) or 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.
> 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 *Sudeley* and *Livingston* cases[8] decided that residuary[9] beneficiaries of

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7 Section 13(10) 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 in the company, ... if when the gain accrues to the company the trustees are neither resident nor ordinarily resident in the UK."

8 See 44.9.1 (Succession law background).

9 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 ecclesiastical courts and not the Chancery courts. That reasoning would apply to a

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. The legatee is nevertheless a "participator" by virtue of s.417(1)(a) ("entitled to acquire") and (d) ("entitled to secure").

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.

It is considered that during the course of administration the legatee does not have an "interest" as a participator.[10] Thus it does not matter that he is a participator because nothing can be attributed to him under s.13.

Admittedly 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. On the contrary, 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 the legatee.

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? Section 62(4) TCGA provides:

> (4) On a person acquiring any asset as legatee ...

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specific legatee as to a residuary legatee.

10 See *Willingdale v Islington Green Investment Co* 48 TC 547 at p.562D. The expressions used in s.13(3) are partially defined in section 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 United Kingdom) 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.

(b) the legatee shall be treated as if the personal representatives' acquisition of the asset had been his acquisition of it.

The legatee is treated as having acquired the shares on the death.[11] 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 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).

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11 See s.62(1) TCGA:

> "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, …"

12 See 35.12.1 (Construction of deeming provisions).

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.

44.5 Deceased UK resident and domiciled

If the deceased was UK resident and domiciled, the PRs are liable to CGT on all chargeable gains (less losses). They pay CGT at the same rate as trusts. In the case of assets which were owned by the deceased, the PRs' acquisition cost is normally the market value at the date of the death.[13] 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 foreign domiciliary. 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 foreign domiciliary (or a non-UK resident, or a charity), he will often be able to dispose of the asset in due course free of CGT.

It is thus a fundamental principle of CGT planning that PRs should generally avoid, wherever possible, making disposals of assets which are devised or bequeathed to foreign domiciliaries, non-residents or charities.

44.6 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

13 s.62(1) TCGA.
14 s.62(4) TCGA.

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.

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.

It has been argued that the HMRC view is wrong. This would, however, 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. It has been suggested that the reference to domicile in s.62(3)[b] is otiose on the HMRC view, because (if the remittance basis is inapplicable) the domicile of the PRs is irrelevant for CGT. However, domicile of PRs could be relevant for the purposes of s.87 TCGA if PRs receive a capital payment from an offshore trust. Where the PRs are not UK domiciled, they will not pay CGT on capital payments from a non-resident settlement (because those charges only arise on a payment to a UK domiciled person).

It seems plain on (almost) any view that gains of non-resident companies may be attributed to PRs who are resident but not UK domiciled; see s.13 TCGA. This is consistent with the HMRC view that the remittance basis does not apply in these cases.

For these reasons it is considered that the HMRC view is correct. 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.

In what follows it is assumed that the PRs are UK resident for CGT.

44.7 Gift of pecuniary legacy to foreign domiciliary: CGT planning

Suppose that a foreign domiciliary 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. Can this liability be avoided by the PRs agreeing to transfer the property to the foreign domiciliary in satisfaction of his pecuniary legacy?

The strategy is viable provided the foreign domiciliary acquired the asset "as legatee", so that s.62(4) TCGA would prevent the PRs realising any chargeable gain. This 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.

"Legatee" is defined by s.64(2) to include "any person taking under a testamentary disposition...". Section 64(3) 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, provided that the PRs had the power of appropriating the asset in satisfaction of the legacy, then the foreign domiciliary could properly be said to take as legatee.

Suppose, however, the PRs had such power only with the consent of the foreign domiciliary? The wording of s.64(3) is in the author's view wide enough to cover this case too.[15]

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15 Although for stamp duty purposes, it was held 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

If, however, the PRs had no power of appropriation, then the "appropriation" could be authorised only on the basis that it was in fact a sale of the asset to the foreign domiciliary for £1,000,000 coupled with a payment of the pecuniary legacy of £1,000,000 by way of set-off. In that case, the foreign domiciliary would acquire as purchaser and not as legatee. Fortunately, PRs will generally have this power: see s.41 Administration of Estates Act 1925.

44.8 Gift of specific legacy to foreign domiciliary: CGT planning[16]

44.8.1 *Succession law background*

This section considers the position where a testator by his will gives assets specifically to a foreign domiciliary. In the first instance, the PRs will acquire the assets and in due course they will receive the income arising from them. If they do not need to use the assets or income for the purpose of paying debts, taxes, etc., they will in due course assent to the vesting of the assets and income in the foreign domiciliary.

44.8.2 *Capital gains tax*

In the first instance the PRs are deemed to own the asset and, if they dispose of it, are liable to CGT. If they do not dispose of the asset to a third party but assent to it vesting in a legatee, then the PRs, as it were, retrospectively pass out of the picture and the legatee is deemed to have acquired the asset at the same time as the PRs acquired it. This would normally be at the time of the death of the deceased.

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. Here the doctrine of relation back does not apply. In the first instance, the common

> 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, however, before the enactment of what is now s.64(3) TCGA (by the FA 1969). This has brought the law into line with what was formerly HMRC practice.

16 For IT, see 44.15 (Specific legacy to foreign domiciliary: IT).

law doctrine would appear to operate only where an asset owned by the deceased is subsequently vested in the legatee. Even if this difficulty could be overcome, however, 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 foreign domiciliary does not confer any exemption.

44.9 Gift of residue to foreign domiciliary: CGT planning

44.9.1 *Succession law background*

This section considers the position where a testator gives the whole or part of his residuary estate to a foreign domiciliary absolutely. During the period of administration, the PRs alone are said to be entitled to the assets which are comprised in the residue of the estate. The residuary legatees have legal rights to compel due performance of the administration of the estate, but it has been repeatedly held by courts of the highest authority that the PRs do not stand in the same relationship to their residuary legatees as do trustees to their beneficiaries.[17] Upon completion of the administration, the residuary legatee becomes entitled to the assets which at that time form part of the estate, and any net 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.

44.9.2 *When is administration of estate completed?*

How long does the administration period last? This question has arisen in a number of contexts, including income tax, CGT, estate duty and general succession law, and has given rise to a voluminous case law. In all these contexts the test is the same. 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

17 *Lord Sudeley v Attorney-General* [1897] AC 11; this (rather odd) principle was re-affirmed in *CSD v Livingston* [1965] AC 694.

> 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.

44.9.3 *The HMRC view*

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 the 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 *CIR v Sir 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.

44.10 CGT planning

The general aim must be to avoid realising assets in respect of which the PRs would be obliged to pay CGT.

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 foreign domiciliary subject to a charge for their liabilities under s.36(10) Administration of Estates Act 1925.

(2) The foreign domiciliary sells the asset: any gain on the sale accrues to the foreign domiciliary: s.26(2) TCGA.

(3) Under the charge the proceeds are used to pay the PRs' liability.

44.10.1 *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 foreign domiciliary may in broad terms be free of CGT and a sale before assent will not.

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 foreign domiciliary 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 foreign domiciliary. Then the shares can be sold without CGT and without the formality of a transfer of legal title to the foreign domiciliary.

44.11 Appointment to beneficiary by executors under overriding powers

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.

Where executors exercise a power to appoint trust property to a beneficiary, that beneficiary takes under the appointment "as legatee" and s.62(4) will apply.

The starting point is the rule of trust law 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* 54 TC 311: 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 page 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 also 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": see s.64(3). 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 clear that HMRC accept that an appointee acquires as legatee.

44.12 CGT planning by instrument of variation

Where there is more than one residuary legatee and some are foreign domiciliaries, 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 foreign domiciliary. UK resident and domiciled beneficiaries would instead receive cash or assets without inherent gains. The foreign domiciliary might in due course realise the gains free of tax. There would be an overall tax saving, which could be shared between the foreign domiciliary and the other beneficiaries by negotiation, or which could be allowed to accrue entirely to the foreign domiciliary if the other beneficiaries were so minded.

44.13 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 United Kingdom.
> (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).

44.14 Income taxation of PRs

In the first instance, the PRs pay tax at the ordinary rate (i.e. basic or lower 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.

44.15 Specific legacy to foreign domiciliary: income tax

If the PRs assent to the asset and its income vesting in the beneficiary, something rather peculiar happens. Under the common law doctrine of relation back, the beneficiary is deemed to have been the owner of the asset since the death. The doctrine of relation back operates for income tax purposes: see *IRC v Hawley* 13 TC 327. Thus, the beneficiary will, retrospectively, be treated as having received the income year by year as it arose. The PRs may have paid UK tax. This will retrospectively be treated as being paid by the PRs in a representative capacity on behalf of the beneficiary. Thus, a foreign domiciled beneficiary should be able to reclaim tax paid by UK resident PRs on unremitted foreign income. A non-resident can also reclaim tax (but ESC A14 normally has the same effect). TSE Manual provides at 7490 (October 2002):

> ***Specific legacies***
> A legacy might take the form of a specific asset such as
> - a picture
> - a piece of jewellery
> - the contents of a bank account
> - a shareholding.
>
> If it takes the form of land or buildings in England or Wales, it may be called a devise. The same tax rules apply as for specific legacies. Details are below.
> ***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 *CIR v Hawley* 13 TC 327. The beneficiary cannot however be taxed on or given repayment on income that he did not receive.

44.16 Gift of residue to foreign domiciliary: income tax

It is not possible to appreciate the existing income tax law without understanding the history. In *R v Special Commissioners for Income Tax Purposes, 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 executors' 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 any retrospective title on the residuary legatee to such income as income. So income tax paid by the PRs still 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, with the unfairness of which they did not seem at all concerned. But subsequently, predictably, individual residuary legatees successfully contended[18] that they were not liable to super-tax (which became surtax in 1927 and is now higher rate tax) on the income of the residuary estate arising during the course of administration. HMRC then realised they had made a rod for their own backs. Legislation was therefore brought in which is now to be found in Chapter 6 Part 5 ITTOIA.

44.17 Absolute/limited/discretionary interests in residue

The legislation distinguishes between:

(1) an absolute interest in residue,

(2) limited interest in residue, and

(3) discretionary interest in residue.

Section 650 ITTOIA provides the definitions:

> (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—

18 e.g. *Corbett v IRC* 21 TC 449. There are several income tax cases on the issue of whether administration was completed.

(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.

(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.

44.18 "UK estate" and "foreign estate"

The legislation also draws a distinction between a "UK estate" and a "foreign estate". These terms are defined in s.651(1) ITTOIA:

> "UK estate", in relation to a tax year, means an estate 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.

44.18.1 *Conditions A and B*

Section 651(2)–(4) ITTOIA provide:

> (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.
> (4) For the purposes of conditions A and B sums within section 680(3) or (4) (sums treated as bearing tax) are ignored.

I find it hard to see what condition B adds to condition A.

44.18.2 *Condition C*

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).

Section 680(3)(4) apply (in short) to UK dividend income and gains from life policies.

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 which does not satisfy conditions A or B.

44.19 Charge on income of 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.
> (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.
> (4) 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).

44.20 Charge on income of foreign estate

Section 657 ITTOIA provides:

> (1) In the case of a foreign estate, tax is charged under section 649 on the full amount of estate income treated as arising in the tax year.

(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.

Section 658 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.

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.

44.21 "Basic amount of estate income"

There are three definitions of "basic amount of estate income" for absolute, limited and discretionary interests.

44.21.1 *Basic amount of estate income: absolute interests*

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 "assumed income entitlement" is (in brief) calculated as follows. First one calculates the "aggregate income of the estate". This has a complex but broadly commonsense definition in s.664 ITTOIA. Then one deducts "allowable estate deductions" to obtain the "residuary income of the estate": s.666 ITTOIA. The assumed income entitlement is the person's share of the residuary income, less tax paid by the PRs: s.665 ITTOIA.

44.21.2 *Basic amount of estate income: limited interests*

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.

44.21.3 *Basic amount of estate income: discretionary interests*

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.

44.22 Non-resident beneficiary of UK estate

ESC A14 (amended August 2005) provides:

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.

CHAPTER FORTY FIVE

WHO IS THE SETTLOR?

45.1 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

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1 See 14.1 (Settlor-interested trusts) and 30.3 (The s.86 charge).
2 See 33.1 (Excluded property for IHT).
3 See s.54 IHTA.

a settlor, or the only settlor, for tax purposes.[4]

45.2 Definitions of "settlement"

Before discussing "settlor" we need to discuss "settlement".

45.2.1 *Three definitions of "settlement"*

We need labels for the different definitions, and I use the following terms:

(1) *The standard IT/CGT definition of settlement*
This definition applies in ITA and TCGA unless the context otherwise requires. In some cases the context does "otherwise require" because there is a separate definition of "settlement". I cannot think of any other case where the context would "otherwise require". The legislation is set out in full in ITA and TCGA, but there are no significant differences, so I give the text of ITA and the TCGA references only.

(2) *The broad definition of settlement*
This is the definition which applies for the purposes of the IT settlement provisions. It is applied by reference in various other contexts. This label is not ideal but I cannot think of a better one. In earlier editions I called it *the* IT definition but this usage is inappropriate following the introduction of the standard IT/CGT definition in 2006, and also the broad definition is adopted for several purposes for CGT.

(3) *The IHT definition*: the definition for the purposes of IHT.

45.2.2 *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

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4 On nominal settlors see *Drafting Trusts and Will Trusts*, James Kessler QC, 8th ed. para 10.14.

> 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[5] 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.[6]

This is strictly a definition of "settled property" not "settlement" but, as subs.(4) illustrates, the cognate expression is used with the same meaning.

45.2.3 *Broad definition of "settlement"*

Section 620(1) ITTOIA provides:

> In this Chapter "settlement" includes[7] any disposition, trust, covenant, agreement, arrangement or transfer of assets....

HMRC rightly say in TSE Manual:

> **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 *CIR v Plummer* (54 TC 1). Bounty is the provision of value without

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5 These terms are defined in s.466(5) (6):
"(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."

6 The CGT equivalent is in sections 60, 68 TCGA 1992.

7 The context shows this is an exhaustive definition, i.e. the word "includes" really means "means".

any corresponding quid pro quo, usually a gift or a transfer at less than full value.

"Bounty" has remained the technical term used by lawyers here, though the word is no longer normally used in this sense. The requirement, put in plain English, is that the settlement must be made with gratuitous intent.

45.2.4 *Is an estate or will trust a "settlement"?*

The question whether an "income tax settlement" includes an estate of a deceased person, or a trust under a will or intestacy, does not arise for the purposes of the IT settlement provisions. Even if it is a "settlement" the settlor, that is, testator (being dead) will not be subject to tax. The broad IT definition of "settlement" is used in other contexts where the issue does arise; see 44.3.1 (Is an estate a "settlement" within s.87 TCGA?).

45.2.5 *IHT definition of settlement*

The IHT definition of settlement is different again.[8] This definition does not include a "bounty" test, and although differently expressed, for present purposes it is effectively the same as the standard IT/CGT definition.

45.3 Definitions of "settlor"

45.3.1 *Five definitions of "settlor"*

We need labels for the different definitions, and I use the following terms:

(1) *The common IT/CGT definition of settlor.* This definition applies in ITA 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 common IT/CGT definition does not apply for the IT settlement provisions or for s.86 TCGA, so it is not usually very important. The legislation is set out in full in

8 The definition is discussed in another context at 49.1.1 (Is a Liechtenstein foundation a "settlement" for IHT?).

ITA and TCGA, but there are no significant differences, so I give the text of ITA and the TCGA references only.

(2) *The broad settlement definition of settlor.* This is the definition which applies for the purposes of the IT settlement provisions. It is applied by reference in various other contexts.

(3) *The CGT s.86 definition:* the definition for the purposes of s.86 TCGA.

(4) *The CGT s.77 definition.* This is similar to the CGT s.86 definition, and is not separately discussed here.

(5) *The IHT definition of settlor:* the definition for the purposes of IHT.

45.3.2 *The common IT/CGT definition of settlor*

Section 467(1) ITA provides:[9]

> 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(3) ITA explains when 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), or
> (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.

9 The CGT equivalent is s.68A TCGA.

Section 467(4) is necessary to avoid doubt whether a will trust is a settlement.[10]

> (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 broad settlement definition, the only difference is that the wording is recast in accordance with the conventions of plain English drafting and will trusts are included. So the five parts of the broad settlement definition discussed below apply here too. The expression "entered into" is inapt in this context though it does no harm.

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 has no equivalent in the other definitions of "settlor", though it might, perhaps, be implied.

10 See 44.3.1 (Is an estate a "settlement" within s.87 TCGA?).

45.3.3 *"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).

45.3.4 *Broad settlement definition of settlor*

Section 620 ITTOIA provides the definition for the purposes of the broad settlement provisions:

> (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[11] if he has:

(1) made the settlement directly or indirectly;

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11 "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 represent exhaustive (not inclusive) definitions.

(2) "entered into"[12] 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;[13] or

(5) made a reciprocal arrangement with another person to make or enter into the settlement.

45.3.5 *IHT definition of settlor*

Section 44(1) IHTA provides the IHT definition:

> In this Act "settlor", in relation to a settlement, includes[14] 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

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12 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 provisions only) the word "settlement" has an extended meaning and includes an agreement or arrangement. One is said to "enter into" an agreement or arrangement even though it is perhaps not normal usage to say that one "enters into" a settlement (in the narrower trust sense). The drafter of the common IT/CGT definition did not realise this, so he included the words infelicitously, though no harm is done.

13 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 common IT/CGT definition included the words; if he had thought about this he would presumably have omitted then, but no harm is done.

14 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.

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 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.[15] The attraction of this view is that it makes the "who is the settlor" area of tax law much more coherent if substantially the same test applies for all the taxes.[16]

45.3.6 *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 paragraph (a) above;
> (c) so much of any property representing both property falling within paragraph (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—
> (a) property or income provided by the other person in pursuance of the arrangements shall be treated as provided by the settlor, but

15 See 45.22 (Minor settlors).

16 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" for IT where the word includes "arrangement". The drafter may have considered cases where it may have been argued that A is a settlor of a settlement for IT purposes (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 settlement in the narrow sense. To anticipate such arguments the drafter added the words "or in connection with".

> (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).

45.3.7 *Settlor "in general sense" and other meanings of "settlor"*

In keeping with the patchwork nature of UK tax law, these definitions are based on a common framework but they all have slight differences from each other. The broad settlement definition dates back to 1936 and is the ancestor of the other definitions. In IHT there has been a little tidying up of the broad settlement definition; the CGT s.86 definition is perhaps an attempt to extract its essence. Cases on one statutory provision will generally be relevant to them all. The concept underlying the definitions represents the normal meaning of the word in trust law.[17] There are circumstances where a person is a settlor within the IT settlement definition but not otherwise, but that is because the definition of "settlement" is different in this context.[18]

There are specific IHT provisions which may affect the identity of the settlor for IHT. So sometimes a person who is the 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 34.1 (Transfers between trusts).

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17 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").

18 See 45.8 (Assignment or surrender of equitable interest).

45.3.8 *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.[19]

The consequences are discussed in 34.4 (The separate settlements fiction); 30.5 (Two settlors for CGT s.86 charge).

45.3.9 *Tainting*

It does not generally matter if someone provides a trivial account 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.[20]

In these cases, the question of when funds are provided may also arise.

45.3.10 *Commentary*

A rational tax system would have one standard definition of settlor, which would apply for all taxes. Five definitions seems extravagant. 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

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19 See 45.4 (Gift from A to B followed by gift to trust by B)
20 See 5.8 (Condition C).

common 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. But it was a deliberate decision:

> Although the idea of moving to just one definition of settlement for all tax purposes is attractive, many of the definitions in the Taxes Acts have arisen either as a response to particular tax avoidance schemes, or to meet the needs of particular taxes. We believe there is a risk that aiming for just one definition would open up loopholes for exploitation. For this reason, we think a more achievable objective might be to aim for a standardised definition for the purpose of taxing UK-resident personal trusts to Income Tax and CGT, but retaining relevant anti-avoidance definitions tailored to the particular needs of those provisions.[21]

I am quite unable to see how a single definition could open up loopholes for exploitation. 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.

45.4 Gift from A to B followed by gift to trust by B

Suppose:

(1) A gives[22] property to B; and

(2) B gives the same[23] property to a trust.

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21 Modernising the Tax System for Trusts (17/12/2004) para 9.

22 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 45.28 (Trust made by IOV).

23 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.

Two "settlor" questions arise:[24]

(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*.[25] 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").

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. ...[The daughter] was content to leave the details to [the mother's advisors]. There was no real likelihood that she would reject the suggestion that she should make the second settlement when Mr Willcox [her advisor] put it to her.[26]

45.4.1 *When is A an indirect settlor?*

The Special Commissioners found:

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24 Other issues may also arise. If A is a beneficiary of the trust, his gift to B may become a gift with reservation: see 35.6.2 (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.

25 67 TC 759. For another aspect of this decision see 45.23 (Agents of settlor).

26 67 TC at 771.

> [the mother] was a settlor of the second settlement having directly or indirectly provided the only funds which were subjected to it.[27]

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" 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.

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27 At page 768G.

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*.[28] 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 45.32 (Tax planning to create trust with foreign domiciled settlor). However, the planning is not all that easy! No looser test can be applied without unworkable 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 if B is a genuinely independent agent.

45.4.2 *If A is indirect settlor, does B cease to be the settlor?*

In *Hatton* the Special Commissioners held that the daughter did not provide the funds for the second settlement.[29] The reason was, it appears, that the mother had provided the funds indirectly and this excluded the possibility that the daughter had provided them at all.

Chadwick J held on the appeal that it was immaterial (for the purposes of the IHT provisions being considered) whether the daughter was also a settlor of the settlement.[30] 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[31] 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

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28 See 45.6 (Appointment to B followed by gift by B).

29 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.

30 Page 791 at B.

31 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 page 791 at B.

clearly the case for the IT and CGT settlement provisions.[32] 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.

45.5 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.*[33]

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.

45.6 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:

32 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.

33 *Mills v IRC* 49 TC at 387 (Buckley LJ).

(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 life-rents 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 – at least until the House of Lords speak again. For implications for tax planning, see 45.32 (Tax planning to create settlement with foreign domiciled settlor).

45.7 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 34.1 (Transfers between trusts).

45.7.1 *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 funds 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.[34]

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 the taxpayer ("A") held £600,000;

(2) a Jersey settlement ("Trust B") made by the taxpayer's brother ("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 [A] the settlor of the £600,000 comprised in the Gibraltar settlement [Trust A]. The taxpayer's brother [B] did not settle 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, 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

34 If at the time of the creation of Trust A, the transfer to Trust B is already in contemplation, then A is plainly 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.

> 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 under the Gibraltar settlement.

The House of Lords approved this reasoning on appeal.[35]

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.[36] The consent of that beneficiary is not needed and therefore that beneficiary is not the settlor of the new trusts.

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 CIR*, 40 TC 416, page 442, and *Chinn v Collins*, 54 TC 311, page 351H.

The same point is made again at 34802.

45.7.2 *Transfer from trust A to existing trust made by B*

Suppose:

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35 It may be objected that this is not consistent with *Fitzwilliam*: see 45.6 (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 para. 49.

36 See *Drafting Trusts and Will Trusts*, James Kessler QC,8th ed., paragraph 11.11 (Power of advancement used to create new trusts).

(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 has provided B's fund directly.

45.7.3 *IT and CGT rule*

Section 470 ITA provides:[37]

> **Transfers between settlements**
> (1) Section 471 applies in relation to a transfer of property 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).
> (2) 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.
> (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.

37 The CGT equivalent is s.68B TCGA.

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 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 all IT and CGT purposes. But since this only restates the general law position, there is no difference here between IT/CGT and IHT.

45.8 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 broad settlement definition[38] 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 the common 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.

45.9 Disclaimer

TSEM states at 1840:

> The person disclaiming is not a 'settlor' within s.660G(1) ICTA [the broad settlement 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:

> 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

38 *IRC v Buchanan* 37 TC 362.

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).

45.10 Variation/resettlement by beneficiaries

45.10.1 *The trust law background*

Beneficiaries who are adult and absolutely entitled to trust property[39] 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").[40]

The distinction between a variation and a resettlement is crucial, but careful drafting will normally achieve whatever is desired.

HMRC accept this distinction. The CG Manual provides:

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39 If there are minor and unborn beneficiaries, a variation can similarly be made with the consent of the court under the VTA 1958.

40 See s.1(1) Variation of Trusts Act 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."

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).

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. Deed of family arrangement [June 2003]

It is quite common for deeds or other instruments of variation of wills or intestacies to be executed within two years of the testator's death. The general guidance is at TSEM1815 and CG31600+. If a deed of variation creates a

> continuing trust which replaces absolute interests in the original will, and there is no election (or from 1 August 2002, no statement of intent in the deed) under TCGA 1992 Section 62(7), or its predecessor CGTA 1979 Section 49(7), 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 TCGA 1992 Section 77. His personal position is considered at CG32000+, assuming the variation is gratuitous.

This is obviously correct. The Manual then turns to our situation:

> **37887.**
> 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.**
> 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. For statutory rules for IoV, see 43.25 (Trust made by IoV).

45.10.2 *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**
> 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**
> 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. Therefore half of any gains will fall within s.77 TCGA because Q is a beneficiary.

45.11 Variation under Variation of Trusts Act 1958

Where a court approves a variation of trust on behalf of a minor beneficiary, under the Variation of Trusts Act 1958, 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 person whose consent is needed: the court has a wider role.[41] Its position is analogous to trustees exercising a power of advancement. But HMRC do not agree. CG Manual para 37902 provides:

> **Identity of settlor**
> 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 authorities justifies the HMRC view.

45.12 Consent to exercise of trustees' powers

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),[42] 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:

(1) A gratuitous consent to an appointment which terminates the consentor's interest in trust income probably makes the consentor the settlor of a "settlement", for the purposes of the broad settlement definition. The consentor has provided income for the purpose of the "settlement" because he has effectively given up his interest in the income by his consent.[43]

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41 *Re Steed* [1960] 1 Ch 407; *Re Remnant* [1970] Ch 560. Further consideration is needed if foreign trust laws apply.

42 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).

43 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 settlement (in the strict sense) who conferred the power of appointment on the trustees. But HMRC

(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" of a "settlement", for the purposes of IT, CGT and (probably) IHT[44] 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 interest in 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:
   (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.[45]

(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.kessler.co.uk*. (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.

44 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.

45 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 to be necessary for Hayley Mills to enter into the arrangements: see 49 TC 367 at p.403. This did not prevent Hayley being a settlor.

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[46] 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.[47]

(5) The giving of the consent is probably not a "disposal" for the purposes of the gift with reservation rule[48] and indeed it is likely that the power of consent is a "settlement power" and so not property for IHT: see IHTA s.272.

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).

45.13 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:

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46 Under general principles or by virtue of s.24 TCGA (extinction of an asset constituting a disposal).

47 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.

48 See *Baird v Baird* [1990] 2 AC 548 at 557 [the exercise of a power of appointment] "disposes of no property of the appointor for the proprietary interest ... arises in default of appointment". 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. This statement makes it less likely that HMRC will argue there is a disposal for CGT.

> 16 The condition in TCGA Sch 5 para 9(3)[49] may be satisfied where property or income is provided to a company in which the trustees are participators.[50]

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 common IT/CGT definition, the broad settlement 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.

45.13.1 *Transactions with wholly owned companies*

SP 5/92 para 18 provides:

> 18 In general, transactions between trustees and companies which they, directly or indirectly, wholly own, or between such companies,
> [1] are outside the scope of TCGA 1992 Sch 5 para 9(3) and
> [2] are not treated as capital payments within TCGA 1992 s 97.
> For this purpose, a company is treated as directly wholly owned by the trustees where the whole of its issued share capital is directly owned by the trustees of the settlement for the benefit of the beneficiaries of the settlement. A company is treated as indirectly wholly owned by the

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49 The condition is that property is provided directly or indirectly for the purposes of the settlement.

50 The SP continues with a limited 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."

> trustees where the whole of its issued share capital is directly and beneficially owned by a company which is directly wholly owned by the trustees or it is the 100 per cent subsidiary of such a company, or a chain of companies, which is indirectly wholly owned by the trustees.

Point [1] is clearly right. There can be no element of bounty so a wholly owned company cannot "provide" property to its owner. Point [2] is doubtful, but this is an entirely different issue, and is outside the scope of this book.

The SP 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.

45.14 Provision of services[51]

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 each case it was held that the actor was the settlor.[52]

Viscount Dilhorne in *IRC v Mills* 49 TC at 408 considered two situations:

(1) The employees of a company, some shares in which were 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

51 See *Taxation*, 13 March 2003, p.572 (Malcolm Gunn). This section will need review after *Jones v Garnett* [2006] STC 283 is final.

52 *Crossland v Hawkins* 37 TC 493; *IRC v Mills* 49 TC 367. More accurately, the actor was one of the settlors but the contribution by the person who made the trust was ignored as insignificant.

settlement.

One might have said that these were not settlors because they provided no bounty. That was not the way that Viscount Dilhorne put it:

> The difference between those cases, on the one hand, and *Crossland v Hawkins* and this case [*IRC v 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? The test is whether one can identify funds which:

(1) would ordinarily (in the absence of the settlement) have been received by the individual, but

(2) were diverted to the trust.

In the case of Viscount Dilhorne's examples of employees and stockbrokers, these conditions are plainly 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, there is nothing one can identify as coming from the advisor. One should not apportion the profits between the advisor'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 capital base (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 is the person
> [1] responsible for making the company's profits and
> [2] decides on the level of dividends paid,[53]
> 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.

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53 It is hard to see the relevance of [2].

Suppose a property developer who is well disposed to the trust gives free property market advice to trustees, and the trustees invest in land 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.

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 in all probability 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.

(2) A person does not provide funds for a settlement if he does so for reward in the ordinary course of his professional business.

These are obvious examples of circumstances in which a person providing services to a trust should not be regarded as a settlor because there is no element of "bounty".

45.15 Interest-free or back-to-back loan

A person who lends interest-free (or on favourable terms) is in principle a settlor. HMRC agree: SP 5/92 paras 19–22.

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: see 46 TC 543 at p.555.

45.16 Indemnities and guarantees

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). Other types of indemnity are considered in light of the facts of a particular case.
> 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.

45.17 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).

45.18 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.[54] The TSE Manual correctly states at 4120:

> ***Example***
> 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.[55]

45.19 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, eg under TA 1988 Part XV may be regarded as the provision of funds for the purposes of the settlement under TCGA 1992 Sch 5 para 9(3).
> [2] The settlement could remain outside the terms of para 9(3) where 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.

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54 This proposition is self evident but if authority is needed, see *Crossland v Hawkins* 39 TC 493 at p.506–7.

55 This is consistent with the principles that a "settlement" must have an element of bounty: see 45.2.3 (Broad definition of "settlement"), and that arm's length sales confer no "benefit": see 17.4.1 (Arm's length bargains).

Point [1] only applies to a failure to exercise rights which is both deliberate and gratuitous (i.e. with an element of bounty).

45.20 Payment of administrative expenses

Payment of trustees, administrative expenses will in principle make the payor a settlor. SP 5/92 provides:

> 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—
> – the trust deed permits payment of capital expenses from income and the beneficiary is entitled only to net income after such payments; or
> – 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

The question, more analytically, is whether the life tenant has provided intentional and gratuitous benefit.

45.21 Life tenant provides 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.

45.22 Purpose: minor settlor

In *Mills v IRC* 49 TC 367, the funds of the settlement were derived from acting work of Hayley Mills, then aged 14. She was supposedly[56] 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.[57] 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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56 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 said this 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*."

57 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.[58]

45.23 Purpose: advisors and agents of settlor[59]

It is submitted 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[60] 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.[61] 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*[62] 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.

45.24 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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58 "The statute seems to me to use the word 'purpose' and 'purposes' indiscriminately"; *Crossland v Hawkins* 39 TC 493 at 507.

59 See 19.16 (Purpose of advisors and agents of transferor).

60 Now s.629 ITTOIA (income paid to unmarried minor children of settlor).

61 See 49 TC 367 at pp.382 and 385.

62 See 45.4 (Gift to B followed by gift to trust by B).

"on his behalf". It is considered that the person lacking capacity is the settlor.[63] 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.[64]

45.25 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.[65] 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.[66]

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.[67]

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63 Sections 16, 18(h) Mental Capacity Act 2005. The tax position is the same for settlements made under the Mental Health Act 1983.

64 Court of Protection Practice Note, 15 November 1996, para 4.

65 See *Drafting Trusts & Will Trusts*, James Kessler QC, 8th ed., Chapter 23 (Trusts of damages).

66 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.

67 *Zim Properties v Proctor* 58 TC 371.

But HMRC accept in practice that there is no settlor.[68] It would follow that the trust fund is excluded property, e.g. if it is an AUT, an OEIC, or not UK situate.

45.26 Trust under Criminal Injuries Compensation Scheme

An award under the Criminal Injuries Compensation Scheme may be transferred to a trust.[69] The applicant under the Criminal Injuries Compensation Scheme is not the settlor of such a trust.[70] That is consistent with the position under the Variation of Trusts Act 1958. However, HMRC have apparently expressed the view that the claimant is the settlor, and in practice this view will often favour the taxpayer.

45.27 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.[71] The taxpayer argued that for this reason that there was no "settlement" within the broad settlement definition. The argument was rejected and the taxpayer was held to be the settlor. The judge tentatively reconciled his decision with the bounty test 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 fact of things made under compulsion".[72] This is romantic nonsense, as any family lawyer will attest. The better way to justify the decision is to note that the bounty test 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".[73] So

68 Private correspondence.

69 Paragraph 50 Criminal Injuries Compensation Scheme 2001.

70 The drafter of Part 2 Chapter 4 FA 2005 seems to have assumed this. Settlor-interested trusts are outside the scope of the provisions: see s.25(3) FA 2005.

71 58 TC 569 at p.572.

72 58 TC at p.577.

73 *Yates v Starkey* 32 TC 38 at p.53.

this is simply an exception to the bounty test. On this analysis, *Harvey v Sivyer* was correctly decided, though not for the right reasons.

45.28 Trust made by instrument of variation

45.28.1 *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 45.4 (Gift from A to B followed by gift to trust by B).

45.28.2 *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
> · 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.

45.28.3 *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.

45.28.4 *Settlor for CGT: variations before 6 April 2006*

The identity of the settlor for CGT is an unresolved question.[74] 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

(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-

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74 See "*Marshall v Kerr* Revisited", *Taxation*, 3 May 2001 (Christopher Sokol QC).

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 (June 2003) provides:

> The Revenue considered that Section 62(7) [TCGA] 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*, preferred slightly different reasoning in holding that a residuary legatee, who had executed an instrument of variation so that her 50% share of the estate was settled, was the settlor for the purposes of Section 87 TCGA (charge on beneficiaries of non-resident settlements). This decision should be applied for the purposes of Sections 77 & 86 TCGA (charge on settlors of certain settlements) and Schedule 1 TCGA (annual exempt amount for trustees).[75]

75 Likewise TSEM 1815:

> "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."

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.

45.29 IT and CGT: variations from 6 April 2006

Section 472 ITA provides:[76]

> (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),
> 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,[77]
> (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,

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76 The CGT equivalent is s.68C TCGA.

77 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 paragraph (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."

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 common 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 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.[78] 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 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.

45.29.1 *Critique*

What is the reason for s.473? Perhaps because it can be hard to identify settlors on 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.

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78 See 45.10 (Variation/resettlement by beneficiaries).

45.30 Pension trusts and employee trusts

45.30.1 *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 non-bounty trust. An example is an employee trust made by the employer for his own benefit. The position is as follows:

(1) A non-bounty trust is a settlement within the standard IT/CGT and IHT definitions of the term.

(2) A non-bounty trust is not a "settlement" within the broad definition.[79]

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.

45.30.2 *Who is the settlor of a pension or employee 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 non-bounty trust.

(2) To make or enter into a settlement does not require an element of bounty, so a non-bounty trust may have a settlor in that sense.

CG Manual 33240 (June 2003) provides:

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79 See 45.2 (Definitions of "settlement").

> 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 common IT/CGT definition, the broad settlement definition, and the IHT definitions of "settlor". These use the words "made" or "entered into". The argument does not run for the CGT s.86 or s.77 definitions.[80] HMRC accept this. CG Manual 34804 (June 2003):

> 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 non-bounty settlement is in fact a settlement for the purposes of s.77 but s.77 does not apply because the company is not within the s.77 definition of settlor. The CG Manual continues:

> 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 Paragraph 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.

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80 The Revenue Booklet "The tax treatment of Top-Up Pension Schemes", para 2.7.5, provides:

> "The 'benefit to settlor' rules in Part XV Taxes Act and FA 1988, Sch.10 [TCGA, s.77–TCGA, s.79] 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."

45.31 Trust made by company

The IT settlement provisions (clearly) and the CGT settlement provisions (probably) do not apply to companies in any circumstances. The context suggests that only individuals are intended to be caught. HMRC do not accept this for CGT.[81] 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) will often be settlor(s) because they provide property indirectly.[82]

45.32 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 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

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81 The CG Manual provides:

> "**35020. Trusts for employees**
> There is nothing in Section 77 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*, James Kessler QC, Key Haven Publications, 5th ed, para. 16.2.2 (Corporate lender).

82 Contrast 16.3.2 (Transfer procured by individual).

W have a genuine and wholly independent role?[83] 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[84] 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.[85] But it is different if B is acting at the behest of the settlor.[86]

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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83 See 45.4 (Gift from A to B followed by gift to trust by B).

84 W may also need tax advice, but what matters here is that W has independent advice on the property law aspects of the gift.

85 See 45.6 (Appointment from old trust to B followed by gift to new trust by B).

86 See 45.5 (Trust created by B at the request of A).

CHAPTER FORTY SIX

SITUS OF ASSETS FOR IHT

46.1 Concepts of situs

Situs[1] of assets is relevant for many tax and non-tax purposes of which the most important for the foreign domiciliary 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 developed for tax and non-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. 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. As a third tier of complexity, some IHT double tax treaties override the usual IHT situs rules.[2] The income tax rules are different: see 8.4 (Why does situs of source matter?).

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

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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 40.5 (Treaty situs rules).

jurisdiction. There is a large choice of possible connecting factors, and the selection of the determining factor must sometimes be arbitrary.[3] 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.

46.2 Every asset has one situs

Under the common law rules,[4] every asset is situate in one jurisdiction[5] and only in one jurisdiction. In *R v Williams* [1942] AC 541 at 559 the Privy Council said:

> Property, whether movable or immovable, can ...[6] have only one local situation.[7]

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3 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". 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 even "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.

4 This rule can be altered by statute, and for CGT it has been, but only in minor respects: see 47.23 (Intellectual property).

5 *English Scottish and Australian Bank v IRC* [1932] AC 238.

6 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.

7 Likewise *Laidley v Lord Advocate* (1890) 15 App Cas 468 at 483: "locality cannot be both England and India—the choice has to be made between the two".

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 only be situate in one place. I stress this as some old cases considered assets could be dual situate. They no longer represent the law.

46.3 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.

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?

46.4 Situs of registered shares[8]

46.4.1 *Place-of-register rule*

The IHT Manual provides:

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8 See "The Situs of Registered Shares", Robert Venables QC, PTPR Vol 9 p.115.

> **27121 Inscribed[9] and registered securities:[10] 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*.[11] 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.[12] 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 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.

46.4.2 *Company with more than one share register*

Multiple registers raise a problem for a place-of-register rule. If there is

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9 "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".

10 "Securities" here includes shares as well as debt securities.

11 (1857) 2 H & N 339 accessible on *www.kessler.co.uk*. This was approved in *AG v Winans (No. 2)* [1910] AC 27.

12 A "register" is only a record of stockholders and their assignees: see *Ramsay v IRC* 54 TC 101 at p.133.

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 helps:

> **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 para.4 Sch 14 Companies Act 1985, 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 Sch 14 para.5.
> 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 Companies Act 1985 s.362 a company may maintain an overseas branch register. The countries and territories in which overseas branch registers may be kept are specified in Sch14. Companies Act 1985 Section 362 (4) and (5) enable 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.

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**
> 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.

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 of the location of a (signed and endorsed) share certificate acting as a tie-breaker between two competing jurisdictions (each with a share register).[13] The Manual continues:

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13 IHT Manual para. 27150:

> "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 (IHTM 01081) or your Team Leader, in Scotland."

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.

46.4.3 *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 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).

46.4.4 *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.

46.4.5 *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.

46.5 Registered debt securities[14]

The rules 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.

46.5.1 *Place-of-register rule v specialty rule*

Shares are not "specialties" so the specialty rule cannot apply to them.[15] 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:

> **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 registered securities are in fact "specialties", see 46.12.3 (Situs of specialty).

46.6 Bearer documents

The place-of-register rule cannot apply to bearer shares as there is no register of shareholders.

46.6.1 *Bearer shares*

The general principle is that the shares are situate where they can be legally transferred, see 46.3 (General principle). Applying this rule it is clear that bearer shares are situate where the certificate is held.

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14 I use the term "debt securities" to mean securities which are not shares.

15 See 46.12 (Specialty obligations).

46.6.2 *Bearer debt securities*

The leading case is *AG v Bouwens*.[16] 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[17] 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 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[18] and by the Manuals. The IHT Manual provides:

> **27076 - Locality of assets (situs): bearer securities**[19]
> 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 – see *Att Gen v Bouwens*,[20] *Winans v Att Gen* [1910] AC 27.

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16 (1838) 4 M & W 171 accessible on *www.kessler.co.uk*. This was approved in *AG v Winans (No. 2)* [1910] AC 27.

17 The situs rule turned on 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.

18 *The Conflict of Laws*, 13th ed, 2000, para.22-044. But for a dissenting view, see 46.7 (Letter of allotment of shares).

19 This passage applies to both shares and debt securities.

20 (1838) 4 M & W 171 accessible on *www.kessler.co.uk*.

46.7 Letter of allotment of shares

A letter of allotment confers the right to an issue of shares. The letter is normally transferable by delivery and so in some respects similar to a short-term bearer share. 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[21] 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 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

21 See 46.6 (Bearer documents).

> 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.[22] 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

22 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 much more 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).

> 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. The case clearly has no application to bearer shares, since it is not consistent with the general test for situs of shares: see 46.3 (Situs of shares: general principle). The case could arguably be relevant to bearer debt securities. It is suggested that the reasoning should be restricted to short life assets (such as letters of allotment which, it was stressed, have a life of only two months).

Even letters of allotment may be situate where the letter is situate, if there is a "market" there.

46.8 Eurobonds and 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:

> **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.

([1994] PCB 139)

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 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).
>
> 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.
>
> **50242. Tax analysis**
>
> 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.
>
> **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.

Now, the general common law 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.[23] But a DR is unlike an ordinary bare trust in that it can readily be dealt with (i.e. transferred) in the jurisdiction of the depository. That is the jurisdiction where litigation over the transfer of a DR is likely to take place, and the better view is that that is the situs of the DR; the situs of the underlying shares 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

23 See 46.25 (Bare trust or nomineeship).

database in which the entitlements of the depositors are recorded.[24]

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. But in practice IHT on such assets is largely uncollectable. It is likely that HMRC will back down on this point if pressed.

46.9 Share certificate indorsed in blank

The IHT Manual explains the background law as follows:

> **27150 - Locality of assets (situs): share certificates endorsed in blank**
> 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 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:

24 13th 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).

> [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....[25]
>
> [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.[26]
>
> [Paragraphing added]

The HMRC view is that one ignores the fact a share transfer form has been indorsed in blank. This is right, because the indorsed certificate does not alter the place where the shares are dealt with as between shareholder and company: see 46.3 (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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25 Omitted text set out at 46.4.2 (Multiple share registers).

26 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.

46.10 Simple[27] contract debt

The IHT Manual provides:

> **27091 - Debts: contractual**
> In English law, a **simple contract** debt is situated where the debtor resides: *Att Gen v Bouwens*;[28] *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.[29]

A winding up order against the debtor does not affect the situs of the debt,[30] but judgment against the debtor (turning the debt into a judgment debt) does do so.[31]

46.11 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.[32] 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 paras 36, 37 upheld the place-of-debtor rule regardless of where the debt would be enforced:

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27 A "simple" contract is one which is not a specialty. Different rules apply to judgment debts and bank accounts: see below.

28 (1838) 4 M & W 171 accessible on *www.kessler.co.uk*.

29 *English Scottish & Australian Bank v IRC* [1932] AC 238 at 248.

30 *Wight v Eckhardt* [2004] 1 AC 147. In practice this issue will not usually arise.

31 See 46.15 (Judgment debt).

32 *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.

> 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 ...
> 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.

46.11.1 *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 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.

46.12 Specialty obligation

46.12.1 *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.[33] A life policy, contract for deferred annuity, capital redemption policy and the like are specialties if made by deed. Shares are not specialties.[34]

(3) The term also includes a debt incurred under a statute, whether or not it is a debt under a deed.[35]

(4) Certain debts are by statute given the nature of a specialty debt.[36]

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".[37] 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.

46.12.2 *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

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33 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 twelve year limitation period).

34 *R v Williams* [1942] AC 541.

35 *Royal Trust Co v AG for Alberta* [1930] AC 144.

36 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."

37 The Law Commission took this view in Working Paper no. 85 (1985) and Report no. 253, para. 2.12ff.

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 for corporations, though for a document to be a deed the parties must intend it to be a deed.[38]

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.[39]

46.12.3 *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.[40] This rule (like the place-of-debtor rule) can be traced back to Elizabethan times.[41] 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

38 *Aall Trust & Banking Corporation v Samuel McCormick* 2 OFLR 85, Butterworths Offshore Service Cases, Vol 2, p.479.

39 *Alliance Bank of Simla v Carey* (1880) 5 CPD 429.

40 *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.

41 *English Scottish & Australian Bank v IRC* [1932] AC 238 at 248.

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 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 46.4 (Situs of registered shares).

46.12.4 *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.
>
> (Paragraphing added)

I find the comments relating to Scotland somewhat surprising and would be grateful to any reader who could direct me to relevant Scots authority.

46.12.5 *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[42]: 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[43]; and, unlike such debts, were enforceable against the real estate.[44] 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".

42 This rule was abolished by the Civil Procedure Act 1833.
43 This rule was abolished by the Administration of Estates Act 1869.
44 This rule was abolished by the Administration of Estates Act 1833.

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 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".[45] 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

45 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.

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 abolished (if at all) by Parliament.[46]

46.13 Debt secured on land

46.13.1 *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.

46 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.

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.

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 judgement 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.[47] 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,[48]

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47 See 46.2 (Every asset has one situs).

48 [Dicey's footnote] *Re Hoyles* [1911] 1 Ch 179.

[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.[49] …

[3] In the conflict of laws the distinction between the interest in land 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.[50]

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[51] suggests that the HMRC view is (like mine) that the specialty prevails, not the location of the land.

46.13.2 *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).

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49 [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.

50 Dicey's footnote refers to: *Re Hoyles* [1911] 1 Ch 179; *Dicey* para. 22–012; Falconbridge, *Selected Essays on the Conflict of Laws*, 2nd ed. 1954 pp.573–580.

51 46.12.3 (Situs of specialty); note the references to mortgages in the quotation from the IHT Manual.

The arguments of principle suggest the simple debt rule prevails. This conclusion is also supported by the passage from *Raiffeisen* cited in 46.10 (Simple debt situs for IHT). This conclusion is consistent with the position for specialty debts secured on land.

46.14 Debt under letter of credit

The IHT Manual para. 27091 provides:

> 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).

46.15 Judgment debt

A judgment debt is situate where the judgment is recorded.[52] Obtaining judgment may therefore have the effect of changing situs, for better or worse.

46.16 Bank account

The IHT Manual provides:

> **27093 - Debts: Bank accounts**
> 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.[53]
> This general law rule may be modified for IHT purposes by a Double Taxation Convention ...

UK bank accounts may, however, qualify as excluded property; see s.157 IHTA. Guidance on what constitutes a branch of a bank can be found in the discussion of branch and PE.[54]

46.17 Building society account

A standard form building society account is not a debt, it is an interest in

52 *AG v Bouwens* (1838) 4 M & W 171 accessible on *www.kessler.co.uk*.
53 In the Law Reports the name of this case is: *The King v Lovitt.*
54 See 12.19 (Meaning of "PE"); 12.26 (Meaning of "branch or agency").

the society, so corporation situs rules rater than debt rules should be applied.

The IHT Manual provides:

> **27151 - Locality of assets (situs): [bank or][55] 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.

46.18 Insurance policy

For the purpose of situs rules a policy is regarded as a debt, so the place-of-debtor and specialty rules apply.[56] 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) More information on policies can be found from IHTM20000.
> **27102 - Policy monies: 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 monies: policy issued at branch office**
> If[57] 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:

55 The reference to a "bank" in the heading seems to be erroneous since the instruction only relates to building societies.

56 *New York Life Assurance Co v Public Trustee* [1924] 2 Ch 101.

57 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.

> · 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
> · 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.

46.18.1 *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 21.10 (IHT on UK situate policies).

46.19 Land

The IHT Manual provides:

27074 - Locality of assets (situs): land/interest in land (June 2006)
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.

46.20 Securities of international organisations

The IHT Manual provides:

27141 - Securities issued by international organisations: list of non-UK situs organisations
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 1975and s.131(2) FA 1976 respectively.

46.21 Chattels

The rule is what one would expect. The IHT Manual provides:

> Chattels are situated where they happen to be at the relevant time.[58]

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;

58 The text is found twice: IHT Manual para 21047 and 27075. For a concession on works of art see 33.16 (Works of art).

(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.

46.22 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.

46.23 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.

46.24 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.

46.25 Interest under bare trust or nomineeship[59]

The interest of a beneficial owner in property held by a nominee or bare

59 For present purposes the terms "bare trust" and "nomineeship" are identical.

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* [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.[60] 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.[61] 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. 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 ignore 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.

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60 See 46.8 (Depository receipts) and 46.9 (Share certificates indorsed in blank).

61 See the thread in the Trusts Discussion Forum, September 2002, under the heading "Onshore/Offshore" accessible on *www.trustsdiscussionforum.co.uk*.

46.26 Equitable interest under a substantive[62] 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.[63]

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.

46.27 Unit in a unit trust

See 25.4 (Situs of unit for IHT).

46.28 Unadministered estate of deceased person

The IHT Manual provides:

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62 By "substantive" I mean a trust other than a bare trust (nomineeship) or unit trust.

63 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,[64] 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[65]
> 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)

46.29 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 conventional[66] partnership is a chose in action distinct from the assets of the partnership. There are several factors that the Court might have used to determine situs. In practice the selection has fallen on

64 Author's note: Further consideration will be required for jurisdictions other than England and Wales, especially civil law jurisdictions.

65 See s.91 IHTA.

66 That is, a partnership which is not a limited liability partnership. 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.

the place where the partnership business is carried on.[67] This is not necessarily the place where the partners reside: there is no concept here of carrying on business by tacit oversight.[68]

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 paragraph 25094[69] suggests that HMRC may not have reached this view, but it seems clear enough.

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67 See *Laidley v Lord Advocate* (1890) 15 App Cas 482, followed *Commissioner of Stamp Duty v Salting* [1907] AC 449.

68 See 12.1 (UK resident trader rules).

69 "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 FORTY SEVEN

SITUS OF ASSETS FOR CGT

47.1 Introduction

This chapter deals with situs of assets for CGT. For a general introduction to the subject see 46.1 (Concepts of situs).

47.2 Municipal & 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.

47.3 Shares/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 paragraph (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.

47.4 Registered shares/debentures: non-UK company

Section 275(1)(e) TCGA provides:

> subject to paragraphs (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

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2 See 46.4 (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.

47.5 Meaning of "shares" and "debentures"

Section 275(2) provides:

> In subsection (1) above—
> (a) in paragraphs (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 paragraphs (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* paragraph 17.3; *Interests in Securities*, Benjamin, 1st ed., 2000, paragraphs 1.02 and 1.20.

47.6 Bearer shares/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

4 See 47.7 (Ordinary debt).
5 See 46.6 (Bearer documents).

> Association allow it. These are commonly called bearer shares and 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 47.7 (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.

47.7 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.**
>
> The general rule for other debts [non judgment debts] is that the debt is

6 See 46.20 (Securities of international organisations).

situated in the UK if and only if the creditor is situated in the UK. This applies whether the debt is secured or unsecured, Section [275(1)(c)] TCGA.

This provision overrides the UK proper law rule and common law rules such as the specialty rule and the bearer security rule. However, it is subject to the rules relating to:

(1) municipal government securities;[7]

(2) registered debentures of foreign incorporated companies;[8]

(3) debentures of UK incorporated companies;

(4) judgment debts;

(5) bank accounts.

47.8 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

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7 See 47.2 (Municipal & government share and debentures).
8 See 47.4 (Registered shares/debentures).

- 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 purposes.

47.9 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.

47.10 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

9 s.252 TCGA. To this there is one exception, relating to personal expenditure: s.252(2) TCGA.

> 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).

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 (or, better, in accounts held by non-resident trusts).

47.11 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.

47.11.1 *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.

47.11.2 *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 section 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.

47.12 Futures and options

47.12.1 *Definition 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-paragraph (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 paragraph 12(10), bringing currency options within the rules, makes no sense in this context.

47.12.2 *"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.

47.12.3 *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 section 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 paragraph (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 section 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.

10 This is otiose, since it repeats s.275A(4); but it does not matter.

Thus a foreign law future/option over a UK situate underlying intangible asset may itself be UK situate.

EN FB 2005 explain 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 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 paragraph (a) above is to be treated for the purposes of subsection (7) above and this subsection as being so situated at that time.

47.12.4 *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.

47.13 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 section 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.

47.14 Depository receipts

Depository receipts are discussed at 46.8 (Eurobonds and depository receipts) where I set out both IHT and CG Manual statements, and argue that the common law situs rule looks to the situs of the DR, not the situs of the underlying asset. For CGT, the depository normally holds as bare trustees for the investors and 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 I am inclined to agree with the view expressed in the CG Manual though for different reasons to the reasons given there.

47.15 Insurance policies

The situs of policies and bonds rarely matters for CGT, because of the relief for policies, see 21.8 (CGT). UK policies will be UK situate under the UK law rule and for others the common law rule will apply.[12]

47.16 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.

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.

47.17 Chattels

Section 275(1)(b) TCGA provides:

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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 47.11 (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.

> 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 46.21 (Chattels).

47.18 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.

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13 The Manual's view (that under international law ships and aircraft are situate where registered) is erroneous: see 46.22 (Ships and aircraft).

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.

47.19 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.

47.20 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]

47.21 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.

14 See 46.25 (Interest under bare trust nomineeship).

47.22 Unit in a unit trust

See 25.5 (Situs of unit for CGT).

47.23 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 paragraphs (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.

47.24 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 46.28 (Unadministered estate).

47.25 Situs of partnership share

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 is a somewhat scanty foundation for the CGT treatment of partnerships, but it is expanded by SP D12:

> 2 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. 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….
> 6 Payments outside the accounts
> Where on a change of partnership sharing ratios payments are made directly between two or more partners outside the framework of the partnership accounts, the payments represent consideration for the disposal of the whole or part of a partner's share in partnership assets…

Thus for CGT one has regard to the situs of the partnership assets, and the situs of the partnership share is irrelevant.

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.

This puts a LLP in the same position as a conventional partnership. Section 59A contains an anti-avoidance provision which applies where a limited liability partnership ceases to carry on a business with a view to profit, or is wound-up.

CHAPTER FORTY EIGHT

DUTIES OF DISCLOSURE

48.1 Reporting requirement on creation of settlement

There is in principle no obligation to report to HMRC the creation of a trust made by a foreign domiciliary unless that trust receives income or gains subject to UK tax. The position with regard to settlements with a UK domiciled (or deemed domiciled) settlor is governed by s.218(1) IHTA:

> 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.

Several conditions must be satisfied for the duty to apply to a person:

(1) The person must be acting in the course of a trade or profession carried on by him.

Barristers are exempt from this duty. The reason must be that they will usually be instructed by others who are subject to the duty. The duty rests on the firm or company acting and not directly on its employees.

(2) The practitioner must be concerned with the making of a settlement.

This would include not only solicitors who might draft the settlement but other advisors who advise in relation to the creation of a settlement, even if the actual execution of the settlement were delegated to foreign advisors.

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 obviously be restricted to those who are able to provide the relevant information.

(3) The practitioner must know or have reason to believe that the settlor is domiciled in the UK.

"Settlor" for this purpose has the usual IHT meaning: see 45.1 (Who is the settlor?).

A settlement may have more than one settlor.[1] Supposing 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 should be interpreted as referring to the domicile of the settlor at the time the settlement was made because that is the date that matters for IHT.

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1 The separate settlements fiction does not apply for this purpose: see 34.4 (Separate settlements fiction).

IHT Manual para 42993 correctly provides:

> **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'
> - 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.

(4) 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

TCGA Schedule 5A imposes overlapping reporting requirements relating to non-resident settlements made by UK domiciled settlors. But s.218 IHTA is wider in three respects. First, it applies to a deemed domiciliary. Second, it applies to settlements which are not necessarily non-resident under the CGT rule.[2] Third, the CGT duty is imposed on the settlor. The duty here is on the professional advisors.

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. This is unlikely to impede HMRC because they have power in s.219 to require information to be provided by "any person" and they would know from the notification to whom further enquiries could

2 Non-residence for the purpose of s.218 is defined in s.218(3):

> "For the purposes of this section trustees of a settlement shall be regarded as not resident in the UK unless
> [1] the general administration of the settlement is ordinarily carried on in the UK and
> [2] the trustees or a majority of them… are for the time being resident in the UK."
>
> This is quite different from the IT/CGT definition.

profitably be directed.

48.1.1 *Non-resident practitioner*

It is arguable 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. However, it is considered that the requirement that the settlor is domiciled in the UK is sufficient to meet the territorial requirements so that no further territorial limitations should be implied.

48.1.2 *Penalty for failure to disclose*

Failure to make the return can give rise to a nominal penalty.
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.

48.2 Reporting requirement on death of foreign domiciled individual

I consider only the reporting requirements of personal representatives for deaths after 6 April 2004. 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".

48.2.1 *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.

"Appropriate property" is defined in s.216(3) IHTA which provides (so far as relevant):

> Subject to subsections (3A) and (3B) below,[3] where an account is to be delivered by personal representatives ... the appropriate property is—
> (a) all property which formed part of the deceased's estate immediately before his death (or would do apart from s.151A(3)(b) or 151C(3)(b) above), 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 details of excluded property need not be returned. Nevertheless Question 5 of HMRC form IHT 200 (D2) asks:

> Did the deceased leave any assets of any description outside the UK? If so give their approximate value.

There is no legal obligation to supply this information. HMRC form D2 (Notes) tacitly recognises 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.

But refusal to disclose may give rise to further enquiries.

There is no duty to disclose GWR under this section, but see 35.18 (Planning and disclosure).

48.2.2 *Excepted estates*

The IHT (Delivery of Accounts) (Excepted Estates) Regulations 2004

3 Subsections (3A) and (3B) are not relevant here.

provides different rules for so-called "excepted estates". Reg.4(1) provides:

> An excepted estate means the estate of a person immediately before his death in the circumstances prescribed by paragraphs (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.[4] 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 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[5] applies; and
> (c) the value of that person's estate situated in the UK is wholly attributable to cash[6] 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.[7]

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

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4 It is doubtful whether a person who is deemed domiciled qualifies under these heads. 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.

5 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)."

6 IHT Manual 6018 shows that HMRC sensibly "construe" cash widely, so as to include a bank account.

7 See reg.4(5).

information set out in reg.6(2):

> The information specified for the purpose of paragraph (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 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.

48.2.3 *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.

48.2.4 *Commentary*

It is evident that 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 deserves to be recorded:

> 7. **Impact**
> 7.1 These Regulations do not impose new costs on business or charities.

48.2.5 *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 an 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 must appoint foreign executors. Then there is no duty to disclose the assets of the estate.

48.3 Tax return[8]

This subject needs a book to itself. For further reading see "Professional Conduct in Relation to Taxation" (Chartered Institute of Taxation) accessible *www.tax.org.uk*.

48.3.1 *Required disclosure*

The duty of the taxpayer (and of his advisors) is to complete a tax return:

(1) honestly; and

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8 See also 15.16 (Disclosure of TAA issues in tax return) and 19.44 (Motive defence claim in tax return).

(2) without neglect, i.e. taking reasonable care to ensure that the answers given are correct.

The standard of honesty is the ordinary standard of reasonable and honest people.[9] In practice debate normally focusses on neglect. A taxpayer who is not an expert in taxation must leave technical tax issues to his advisors so in practice the issue is normally whether the taxpayer's accountants or other advisors have been guilty of neglect because the properly represented taxpayer cannot be accused of neglect.

Significance of neglect

Normally there is a 6 year limit on assessments. In the case of neglect, assessments may be made up to 20 years from the year of assessment. See Section 34 Taxes Management Act 1970:

> **34 Ordinary time limit of six years**
> 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 later than five years after the 31 January next following the year of assessment to which it relates.

The relevant exception is in s. 36 TMA 1970, which provides:

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9 But what are those standards? It will ultimately depend 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 as an esquire under the act (12 Car. II c.9). 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."

> **36 Fraudulent or negligent conduct**
> (1) An assessment on any person (in this section referred to as 2the person in default") for the purpose 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

The taxpayer may also be subject to penalties if he is personally guilty of neglect.

Meaning of neglect

Enquiry Manual para 5125 correctly provides:

> **5125. Culpability: Neglect, Negligence and Negligent Conduct** [June 2006]
> The terms are interchangeable.

The new penalty provisions in Sch 24 FA 2007 use the word "careless", defined to mean "failure to take reasonable care", and this is another synonym of negligent. 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 therefore is normally what reasonable accountants would do in completing a tax return in any particular situation.

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 rests on HMRC to prove negligence. An allegation of neglect is a serious one and it should not be lightly made. I would stress all these points because HMRC tend to ignore them and allege neglect very casually, where neglect is necessary to justify out of time assessments.

The standard of reasonable care is that to be expected of a reasonable advisor. 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.[10] This rule applies in the completion of a tax return. So where Counsel has advised, the allegation normally has to be that Counsel is guilty of neglect. If the allegation is correct, of course, then Counsel is in principle responsible for any losses caused by the negligence.

Everyone who is responsible for completing tax returns has to ask themselves questions and decide on the answer. If a firm answer is reached, there is in general no obligation to disclose this process of question and answer to HMRC and failure to do so is not dishonest or negligent.[11] The fact that there is a possibility that the courts might disagree with an advisor's view does not call for disclosure.

Full disclosure would be advisable where an individual has carried out an extremely complex, artificial, and aggressive tax avoidance scheme. In such a case (even though it is reasonably considered the scheme will succeed) full disclosure of the transactions should be made in the "white box" section of a tax return, so HMRC have a proper opportunity to review the matter. This avoids any suspicion that the scheme is of the dishonest kind which relies in whole or in part on HMRC not finding out the facts. In practice such cases will generally be caught by the tax avoidance scheme disclosure rules.

For the same reason, disclosure may be advisable where the taxpayer is

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10 *Locke v Camberwell Health Authority* [1991] 2 Med LR 249-254 accessible *www.kessler.co.uk*.

11 The Keith Committee recommended that doubts of this kind should be disclosed to HMRC but the recommendation was 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).

taking a view which is known to be 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 and non-binding publications, such as the HMRC Manuals, and informally published correspondence, but in these cases disclosure is not necessary (i.e. non-disclosure is neither dishonest nor negligent) if the HMRC view expressed is clearly wrong. The mere fact that the view of the law which leads to a failure to disclose is a view contrary to the HMRC view, even a long held view, is not proof of negligence.

48.3.2 *Voluntary disclosure*

HMRC usually have 12 months in which to begin an enquiry into a tax return, beginning with the filing date. However, s.29 TMA 1970 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[12] to him before that time, to be aware of the situation mentioned in subsection (1) above.

The advantage of voluntarily disclosing details in addition to the required 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 all the facts in the white box "additional information" section of the tax return. But as noted, failure to adopt this course does not by itself constitute neglect.

48.4 IHT: voluntary disclosure

The IHT rules are slightly different. A certificate of discharge discharges "all persons from any further claim for the tax on the value transferred by

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12 Section 29(6) 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 paragraphs (a) to (c) above; or

(ii) are notified in writing by the taxpayer to an officer of the Board."

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 ... .

48.5 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 FORTY NINE

CATEGORISATION OF FOREIGN INSTITUTIONS

General approach

The general approach is explained in *Memec v. IRC* 71 TC 77 at p.92:

> When an English tribunal has to apply the provisions of an UK taxing statute to some transaction, arrangement or 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 transaction, arrangement or entity. But having informed itself in this way, the tribunal must then apply the taxing statute as part of English law.

49.1 Liechtenstein foundation (Stiftung)[1]

49.1.1 *Is a Liechtenstein foundation a "settlement" for IHT?*

Section 43(2) IHTA provides:

> "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

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1 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*.

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 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.

Foundation property is normally held "for persons in succession" or "held with power to make payments out of the income". The question is:

(1) whether the property is held in "in trust" or "on trust" (the expressions are synonymous); or

(2) whether the administration of the property is governed by provisions "equivalent in effect".

49.1.2 *Is foundation property held on trust?*

A Liechtenstein foundation normally has legal personality. (In this book I shall not consider those which do not.) 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 clause of a foundation in order to know whether a board of foundation

is entitled to *e.g.* sell some specific foundation property.[2]

On the evidence of the above passage it is considered that property in a foundation is not held "in trust". An essential (or almost essential)[3] characteristic of a trust is that "the assets constitute a separate fund and are not a part of the trustee's own estate".[4] A foundation does not have this characteristic.

49.1.3 *Is a foundation "equivalent in effect" to a trust?*

Whether a foundation is "equivalent in effect" to a trust raises a question of fact as to the effect of a foundation. Lorenz states:[5]

> 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.

Biedermann says:[6]

> Operationally speaking, there is no difference between a family foundation and a family trust.

On the basis of this evidence it appears that a foundation is "equivalent in effect" to a trust and is therefore a "settlement" for IHT. (The contrary

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2 [1993] PCB 283.

3 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.

4 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": paragraph 1-01.

5 *Disputes involving Trusts*, edited by Ledim Vogt, published by C H Beck, 1999, page 213.

6 [1993] PCB 283.

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, it is submitted, looking at the broad substance rather than absolute equivalence.)[7]

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.

49.1.4 *HMRC view*

TDSI Mailshot 6 (17 May 2004) provides:

> **Stiftungs** The current IR view on Stiftungs is that they are Trusts for UK tax purposes. For TDSI [Tax Deduction Scheme for Interest] purposes, the deposit should be considered to belong to the settlor and the TDSI treatment depends on the nature of the settlor–so if the settlor is an individual, LRT [lower rate of tax; now called the savings rate] must be deducted.
> If the settlor can show that they have not retained an interest, the bank or building society can treat the Stiftung as an interest in possession trust and the TDSI position will depend on the nature of the beneficiary. If the beneficiary is an individual, deduct LRT.

49.2 Anstalt

TDSI Mailshot 6 (17 May 2004) gives the HMRC view:

> **Anstalts** The current IR view is that they should all be dealt with as if they are companies. For TDSI, this means that Anstalts should receive gross interest (provided in the case of a building society, the appropriate gross payment declaration (now form 38(INP)) is held).

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7 See also "The Liechtenstein Foundation and UK Tax Avoidance", Robert Venables QC, OTPR Vol.4 p.185.

49.3 American Grantor Trust[8]

The classification of a grantor trust turns on the nature of the rights conferred by the trust, which depends on the drafting and jurisdiction concerned. Only general comments are possible here. Under a typical grantor trust, the settlor (in US terminology, trustor) is sole trustee, the trust is revokable and the income and capital is paid to the settlor on demand. Section 603 of the America Uniform Trust Code[9] provides:

> While a trust is revocable [and the settlor has capacity to revoke the trust[10]], rights of the beneficiaries are subject to the control of, and the duties of the trustee are owed exclusively to, the settlor.

A grantor trust of this kind is not a settlement for IHT and the property in the grantor trust is not settled property for CGT 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." [11] Any rights which purport to be granted under the grantor trust during the lifetime of the settlor (or at least while the settlor is mentally competent) are illusory (unassignable and unenforceable). If I were wrong on that, I would also say that the grantor trust was a bare trust for CGT as the settlor is absolutely entitled as against the trustee see section 60 TCGA 1992, and not a settlement for IHT, since the property is not "held on trust for persons in succession". The element of succession

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8 For other US trusts, see Von E. Sanborn, "US tax classification of trusts", (2005) TQR Vol 3issue 2 p.16 accessible to STEP members on *www.step.org*.

9 Accessible *www.nccusl.org*.

10 Square brackets in original, as the wording is intended to be optional.

11 *Armitage v Nurse* [1998] Ch at 241 at p. 253. Likewise Hague convention article 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."

is that of a will. In other words, a grantor trust is in English terms a testamentary disposition.[12] 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; or if void in English law but valid in US law, appropriate conflicts principles must be applied to see which legal system has priority.

Depending on the wording, the grantor trust may become a settlement (for IHT and for CGT) if the settlor loses capacity to revoke the trust. This could of course have serious UK tax consequences.

49.4 Other entities

Tax Bulletin 83 explains the HMRC views:

> **Foreign Entities: Classifications for UK Tax Purposes**
> This Tax Bulletin updates and supersedes Tax Bulletins 39 and 50. 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 CIR* (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, 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?

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12 Underhill & Hayton agree: Law of Trusts & Trustees, 17th ed para 4.8 fn1.

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.

A list of foreign entities where we have been asked our view on the question of transparency/opacity is set out below. A separate list of foreign entities, which have been considered for Stamp Duty purposes, appears in the Stamp Taxes Manual available on the HMRC website.

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.
- Entities are described 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.
- 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.

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. The following are the contact points ...

List of Foreign Entitites[13] **Country and name of entity**	**UK tax treatment**	**Date last considered**
ANGUILLA		
Partnership	Transparent	10/1991
ARGENTINA		
Sociedad de responsabilidad[14] limitada	Opaque	6/1958
AUSTRIA		
Kommanditgesellschaft (KG)	Transparent	8/1971
Kommand Erwerbsgesellschaft (KEG)	Transparent	11/2003
GmbH & Co KG	Transparent	5/2002
Gesellschaft mit Beschränkter Haftung (GmbH)	Opaque	11/2005
Aktiengesellschaft (AG)	Opaque	11/2005
BELGIUM		
Société privée à responsabilité limitée (SPRL)	Opaque	8/1994
Société en nom collectif (SNC)	Transparent	5/1992
Société Anonyme (SA)	Opaque	11/2005
Naamloze Vennootschap (NV)	Opaque	11/2005
Société en commanditaire par actions (SCA)	Opaque	11/2005
Commanditaire vennootschap[15] op aandelen (CVA)	Opaque	11/2005
BRAZIL		
Sociedade por quotas de responsabilidade[16] limitada (Srl)	Opaque	1/1977
CANADA		
Partnership and limited partnership	Transparent	11/2005
CAYMAN ISLANDS		
Limited partnership	Transparent	11/1993
CHILE		
Sociedad de responsabilidad[17] limitada (SRL)	Transparent	9/2003
CHINA		
Wholly foreign owned entity (WFOE)	Opaque	10/2005
CZECH REPUBLIC		
Akciova spolecnost (as)	Opaque	11/2005

13 I have restored diacritical marks which HMRC somewhat illiterately omitted in Tax Bulletin 83.

14 Original erroneously reads: responsibilidad.

15 Original erroneously reads: venootschap.

16 Original erroneously reads: responabilidade.

17 Original erroneously reads: responsibilidad.

Spolecnost s rucenim omezenym (sro)	Opaque	11/2005
EUROPEAN UNION		
Societas Europeas (SE)	Opaque	7/2005
FINLAND		
Kommandiittiyhtiö (Ky)	Transparent	5/1991
Osakeyhtio (Oy)	Opaque	11/2005
Aktiebolag (Ab)	Opaque	11/2005
FRANCE		
Groupement d'Intérêt economique (GIE)	Transparent	5/1988
Société en nom collectif (SNC)	Transparent	8/2000
Société civile immobilière (SCI)	Opaque	11/2005
Société civile agricole (SCA)	Opaque	2/1998
Société en commandite simple (SCS)	Transparent	9/1997
Société en participation (SP)	Transparent	6/1992
Société à responsabilité limitée (SARL)	Opaque	
Fonds Commun de Placement à risques (FCPR)	Transparent	1/1997
Société par Actions Simplifie (SAS)	Opaque	4/2004
Société anonyme (SA)	Opaque	4/2004
Groupement Foncier d'Agricole (GFA)[18]	Opaque	5/2001
Société Civile (SC)	Opaque[19]	11/2005
GERMANY		
Stille Gesellschaft	Opaque	6/1998
Kommanditgesellschaft (KG)	Transparent	2/1997
Offene Handelsgesellschaft (OHG)	Transparent	9/1996
Gesellschaft mit Beschränkter Haftung (GmbH)	Opaque	2/1997
GmbH & Co. KG	Transparent	2/1997
Gesellschaft des Bürgerlichen Rechts (GBR)	Opaque	4/1994
Aktiengesellschaft (AG)	Opaque	11/2005
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		
Korlatolt felelossegu tarsasag (Kft)	Opaque	11/2005
Reszvenytarsasag (Rt)	Opaque	11/2005
ICELAND		
Hlutafelag	Opaque	11/2005
IRELAND		
Limited Partnership	Transparent	
Irish Investment Limited Partnership	Transparent	
Common Contractual Fund (CCF)	Transparent	1/2004

18 This is a misprint but I do not know what is intended.

19 But a société civile is classified as a partnership in the France IHT DTT: see 40.5.2 (Treaty situs rules: France).

ITALY		
Societa per Azioni (SpA)	Opaque	11/2005
JAPAN		
Goshi-Kaisa	Transparent	2/1997
Gomei Kaisha	Transparent	
Tokumei Kumiai (TK)	Transparent	11/2005
Kabushikikaisha	Opaque	11/2005
Yugen-kaisha	Opaque	11/2005
JERSEY		
Limited Liability Partnership (LLP)	Opaque	2/2001
KAZAKHSTAN		
Limited Liability Company (LLC)	Opaque	9/2005
LIECHTENSTEIN		
Anstalt[20]	Opaque	3/2004
LUXEMBOURG		
Société en commandite par actions (SCA)	Opaque	7/1992
Fonds commun de placement (FCP)	Transparent	5/2005
Société anonyme (SA)	Opaque	11/2005
Société à responsabilité limitée (SARL)	Opaque	11/2005
Société d'investment à capitale variable (SJCAV)	Opaque	3/2006
NETHERLANDS		
Vennootschap Onder Firma (VOF)	Transparent	2/1995
Commanditaire Vennootschap both "open" and "closed" (CV)	Transparent	8/2000
Naamloze Vennootschap (NV)	Opaque	10/1981
Besloten Vennootschap Met Beperkte Aansprakelijkheid[21] (BV)	Opaque	10/1981
Maatschap	Transparent	10/1993
Stichting	Transparent	7/2005
Cooperatie (Co-op)	Transparent	7/2004
NEW CALEDONIA		
Société en nom collectif (SNC)	Transparent	7/2005
NORWAY		
Aksjeselskap[22] (AS)	Opaque	
Kommandittselskap[23] (KS)	Transparent	1/1981
POLAND		
Spolka z ograniczona odpowiedzialnoscia[24] (SP. zo. o)	Opaque	3/1996
PORTUGAL		
Sociedade por quotas (Lda)	Opaque	4/1993

20 See 49.2 (Anstalt).
21 Original erroneously reads: Aansprakelijheid.
22 Original erroneously reads: Alkjeselskap.
23 Original erroneously reads: Kommandittselkap.
24 Original erroneously reads: Spolkaz ograniczonaodpowiedzialnoscia.

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		
Spolocnost's rucenim obmedzenim (sro)	Opaque	11/2005
SPAIN		
Sociedad Civil[25] (SC)	Opaque	12/1980
Sociedad Anonima (SA)	Opaque	11/2005
Comunidad de bienes	Transparent	6/2001
Sociedad de Responsabilidad Limitada (Srl)	Opaque	11/2005
SWEDEN		
Aktiebolag (AB)	Opaque	11/2005
Kommanditbolag (KB)	Transparent	10/2005
SWITZERLAND		
Société Simple (SS)	Transparent	12/1990
Casellschaft mit beschränkter Haftung (GmbH)	Opaque	11/2005
TURKEY		
Attorney Partnership (AP)	Transparent	4/2004
Anonim Sirket (AS)	Opaque	11/2005
Limited Sirket (Ltd/S)	Opaque	11/2005
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)	Opaque	6/1997
Limited Liability Partnership (LLP)	Transparent	12/1999
Massachusetts Business Trust (MBT)	Transparent	2/1980
S. Corporation (S. Corp)	Opaque	7/2005

The Stamp Taxes Manual offers another list (with some overlap) addressing the question of whether a foreign institution 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 and Section 151 purposes:–
>
> 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.

25 Original erroneously reads: Civila.

Bahamas	Companies described as limited.
Belgium	Société de personnes a responsabilité limitée (descussocies).[26]
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' (Osakeyhtio) 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[27] 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[28] (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.
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[29] par actions

26 "descussocies" is a misprint but I do not know what is intended.
27 Original erroneously reads: Kommanditfellschaft.
28 Original erroneously reads: Aktieselscap.
29 Original erroneously reads: commandit.

	and Aktiengesellschaft (AG). A verein.[30]
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.

30 'A verein' is a misprint but I do not know what is intended.

APPENDIX 1

BAKER AND GARLAND TRUST JURISDICTIONS

This list is published by HMRC.[1] The footnotes are my own.

Argentina	No Trust Law
Australia	
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[2]	
British Columbia	Baker
Nova Scotia	Baker
Ontario	Baker
Saskatchewan	Baker
Quebec[3]	Garland
Cayman Islands	Baker
Denmark	Garland
Egypt	Baker
Estonia	Baker
Fiji	Baker
France	No Trust Law
Ghana	Baker
Gibraltar	Baker
Guernsey	Baker
Guyana	Baker
Hong Kong	Baker
Hungary	Baker
India[4]	Garland
Ireland, Republic of[5]	Baker
Isle of Man	Baker
Italy	No Trust Law
Japan	No Trust Law
Jersey[6]	Baker
Kenya	Baker
Latvia	Baker
Liechtenstein	Garland
Lithuania	Baker
Luxembourg	Baker
Malaysia	Baker
Malawi	Baker
Malta	No Trust Law
Monaco	No Trust Law
Montserrat	Baker
Namibia	Garland
Netherlands	No Trust Law
New Hebrides	Baker
New Zealand	Baker
Nigeria	Baker
Norway	Garland
St Helena	Baker
St Vincent	Baker
Singapore	Baker
South Africa[7]	Garland
South Yemen	Baker
Spain	No Trust Law
Sri Lanka	Baker
Sweden	Garland
Trinidad & Tobago	Baker
Uganda	Baker
USA[8]	
New York	Garland
Minnesota	Garland
Montana	Garland
North Dakota	Garland
South Dakota	Garland
Wisconsin	Garland
All other states[9]	Baker
Zambia	Baker
Zimbabwe	Garland

1 *www.hmrc.gov.uk/cnr/nr_trusts.htm#baker_garland_countries.*

2 This seems correct: see *Minister of National Revenue* [1956] SCR 49 especially [1953] Ex. C.R. 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.

3 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).

4 *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."

5 The list omits Northern Ireland: this is a *Baker* jurisdiction.

6 Paul Matthews agrees: *Jersey Law of Trusts*, 3rd ed., para.1.21.

7 Honoré agrees: *South African Law of Trusts*, 4th ed., 1991, para.349.

8 A New York trust was (rather implausibly) found to be a *Garland* trust in *Garland v Archer-Shee* 15 TC 693. The finding of fact in *Garland* was also made in *Timpson's Executotrs 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.

9 This may not be correct. 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.

POSTSCRIPT

The ICEAW Tax Faculty offer ten tax tenets.[1] 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.[2]

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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1 *www.icaew.co.uk/index.cfm?route=128518*.

2 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.